The New York
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Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

BOOK REVIEWS

Successful Tax Practice

By Hugh Bickford. PRENTICE-HALL, INC., New York, N. Y., 1950. Pages: xx + 428; $5.65.

Successful Tax Practice is a semi-autobiographic account by tax attorney Hugh C. Bickford of his experiences to the end that fellow tax practitioners might profit by them. It does not purport to be a learned treatise, or an oversimplified version of the tax law. Nor is it a book of legal forms or of personal anecdotes. Instead, it offers practical advice that should prove helpful to the seasoned tax practitioner as well as the beginner. Its clear and readable narrative, punctuated with appropriate illustrations, aids the author in achieving his objective.

The usefulness of this book is best portrayed by the titles of its chapters. In order of presentation they follow:

1. Introduction to Tax Practice
2. The Facts of the Case
3. Proving Representative Factual Cases
4. How to Prove Fair Market Value
5. How to Prove Value by Comparative Sales
6. How to Prove Value by Other Methods
7. The Working Tools of Tax Practice
8. How to Find the Law of the Case
9. How to Write Opinions and Briefs
10. Controlling the Tax Burden
11. The Preparation of Returns
12. The Bureau of Internal Revenue
13. The Audit Processes
14. How to Protest an Agent's Report
15. Appeal to the Technical Staff
16. How to Obtain a Refund of Taxes
17. Introduction to Court Procedure in Federal Tax Cases
18. Jurisdiction of the Tax Court of the United States
19. Pleadings before the Tax Court
20. Hearing before the Tax Court
21. Tax Practice in the District Courts
22. Tax Practice before the Court of Claims

This book should be required reading for all beginners in tax practice. It might well be used as a text in an introductory course to provide the necesary tax matrix, or in a concluding course to supply a "clinical" resume. Mature tax attorneys will find within the covers of *Successful Tax Practice* some of the strategies a fellow practitioner employed to win his cases.

J. H. LANDMAN

New York, N. Y.

Office Methods, Systems, and Procedures

By Irving A. Herrmann. THE RONALD PRESS COMPANY, New York, N. Y., 1950. Pages: vii + 539; $7.00.

In the words of the author, "this book is adapted to the requirements of anyone interested in efficient operation of the office—the office manager, the methods supervisor, the systems and procedures analyst, the controller, the accountant, the specialist in forms and equipment, and the business man." In this respect, he is correct. This volume will prove most valuable to the *experienced* office manager and other executives. The approach of the volume is that of industrial engineering applied to office work. The objective of industrial engineering is to reduce costs and to increase efficiency. In this case it is applied to office management and operations.

It might be stated that, in the opinion of the reviewer, every office executive interested in modern up-to-date methods of improving his work should have his firm purchase this volume. Furthermore, after carefully reading this volume, the executive should certainly have developed many ideas for improving the quality of the work under his supervision, as well as the reduction of the cost of office work.

More specifically, this volume is divided into nineteen chapters. The first eight chapters discuss in a practical way, with many form illustrations, the subjects of Office Methods Program; Office Survey Techniques, Process Analysis Charts, Summarization Techniques, System and Procedure Design. The last ten chapters relate to Forms—their control, design, preparation. This undue emphasis on forms is no doubt due to the author's realization that so much of office work involves the preparation and use of forms.

The book is copiously illustrated, but as is so often the case, using blank forms without inserting illustrative data makes many of the forms interesting but not very valuable to the reader desiring to learn the "how" of doing the work. The author might be able to explain this by stating that since business firms vary so much from each other, illustrative data would not be helpful. However, the reviewer does not agree with this opinion. If a form is important enough to use as an illustration, it should be shown in its completed form and, if necessary, with a detailed explanation of its use and the method of collecting the data. Perhaps the author feels that an experienced office executive should be able to understand

(Continued on page 263)

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C.P.A., Society member, 10 years experience with Treasury Department, desires connection with busy accounting firm to take charge of its tax work. Will also consider purchase of part interest in such firm, or purchase of an entire practice. Box 255, New York C.P.A.

C.P.A. (N. Y.), Institute member, M.S. Columbia, six years manufacturing, three shipping, desires chief accountantship medium company. Box 256, New York C.P.A.

Accountant—Attorney (N. Y.)

Formerly BIR, Tax Dept. large C.P.A. firm, earning $7,500 plus; now individual practitioner; seeks space, working arrangement with accounting firm, New York City. Box 260, New York C.P.A.

C.P.A., 1934; law degree; responsible diversified experience; desires association with busy accountant; objective partnership or other arrangement. Box 263, New York C.P.A.

Accountant; B.B.A. 1941, passed three parts of the New York State C.P.A. examination. Six years diversified experience; desires position in public or private accounting. E. Amer, CYpress 3-2239.

Book Reviews

(Continued from page 260)

what data should be inserted in the form. That may be true in some instances, but not for all those who need such a volume as this. How others have used the form or illustration is important.

Some of the basic activities of office work are: Dictation, Transcription, Communication and Filing. With the exception of Filing, little attention is given to the others. If this book had been tied in more consistently with Dictation, Transcription and Communication—the office services which take up so much of office costs—its value would have been much more tangible and valuable to the larger number of office managers.

This book is highly recommended to all business executives for what it will do for them—in helping them to reduce the cost of their office work, and improve the efficiency of the work being done. I am glad to have had the opportunity to review the book because it gave me an excellent review of industrial management applied to office work and will prove so valuable from a dollars and cents viewpoint in all my future work.

John J. W. Neuner

The School of Business and
Civic Administration
The City College of New York

Practical Book-keeping and Accountancy

By L. J. Northcott and C. S. Forsyth. Odhams Press Limited, Long Acre, London, 1949. Pages: 576; 12/6.

The approach to the learning of bookkeeping followed by the British authors of this text is not unlike that in most North American books. Here and there the reader must accustom himself to such expressions as "bought" ledger (for accounts payable) and "worked example" (for illustration).

One may question why the topics of partnerships, limited companies and consolidations are introduced before controlling accounts, and why the need for adjusting entries is indicated without showing the manner in which they are made.

The authors prepared their text for those who are concerned with the keeping of business accounts and those who sit for some of the recognized British examinations. Undoubtedly, they had in mind persons who already were familiar with the subject but wanted a reference book. For such persons, the text is adequate. However, for those persons unacquainted with accounting, the detailed explanations which students generally look for in such texts are not always available.

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Book Reviews

(Continued from page 263)

Undoubtedly, British austerity extends to the publication field. The print in the text is very fine and difficult to read and is hardly like that found in standard texts published in this country.

STANLEY B. TUNICK

New York, N. Y.

Uniform Accounting Manual for the Electrical Manufacturing Industry
(Seventh Edition, 1949)

Published by the National Electrical Manufacturers Association, New York, N. Y., 1950; $12.50 (with special discounts).

Thirty-four years ago, the electrical manufacturing industry recognized the desirability of formulating and adopting a uniform accounting system. This volume, the 7th edition of the Uniform Accounting Manual, was designed:

"To help and encourage companies in the industry by their voluntary action to establish more accurately the real costs of doing business, both as to individual products and total operations, as well as to estimate costs of new business; to determine sound inventory values and financial results from operations; and to present such information in a clear and informative manner for the better control and guidance of the various divisions of the business."

This new edition has been completely revised to reflect changes and developments in the field of accounting as applied to the problems and requirements of the electrical manufacturing industry. The manual not only contains chapters covering the classification and definition of accounts and accounting for investment in plant and equipment, but also includes a comprehensive section on cost accounting. This section, an outstanding feature of the book, contains an excellent discussion of standard manufacturing costs and analysis of cost variances which, although addressed primarily to the electrical manufacturing industry, can be read advantageously by manufacturers in other fields, as well as by practicing accountants and students of cost accounting. The discussion is not confined solely to manufacturing costs but also contains an adequate treatment of product engineering, distribution and administrative costs.

The manual also includes a section on financial and operating statements and ratios and contains a generous number of tables and exhibits spaced throughout the manual which are of great assistance to the reader. A comprehensive index completes the volume.

The subject matter has been arranged in such a manner as to be useful to companies of all types, ranging from the small to the very large organization, and from those carrying a single product line to those carrying multi-product lines. The excellent mechanical makeup and typography of the manual greatly facilitates its usage.

This current revision of an already excellent manual will serve as an invaluable guide to members of the electrical manufacturing industry and to all others concerned with the development of uniform cost accounting systems.

BERNARD BARNETT

New York, N. Y.

Lawyers' Tax Manual (Procedure—Transactions—Forms)

By Alfred S. Pellard. CLARK BOARDMAN COMPANY, LTD., New York, N. Y., 1949. Pages: xxiii + 582; $12.00.

There seems to be no limit to the number and variety of books on federal tax matters which the business man and his tax advisors can absorb. This one, Lawyers Tax Manual, is directed by the author to the general law practitioner who is not a specialist in tax law. The author comments in his preface that while it is not expected that a general practitioner should be a tax expert, he nevertheless should have a reasonable familiarity with the tax angles of transactions to be consummated or documents to be drawn. Since the same comment as to need for general tax knowledge could equally well be made for the public accounting profession, which also has developed a "branch" specializing in taxes, the manual may well be of interest to the readers of this magazine.

The book is divided into two broad divisions—a discussion of tax procedures and forms, and a larger coverage of specific tax topics, including wills, trusts, estates, gifts, and specific business problems—real estate transactions, etc.

Your reviewer considers the chapters on tax procedure and forms of much greater potential interest and usefulness to the accountant who, if not primarily interested in tax matters, must necessarily have a general familiarity with the problems as they affect his professional activities. The division by paragraphs of a general explanation of the subject, leading through specific facets to the contents of the forms involved makes for very easy reading. The detailed drafts of standard forms—powers of attorney, protests, etc.—well merit review by accounting practitioners.

It is hard for the new accounting practitioner to find a well written and concise ex-

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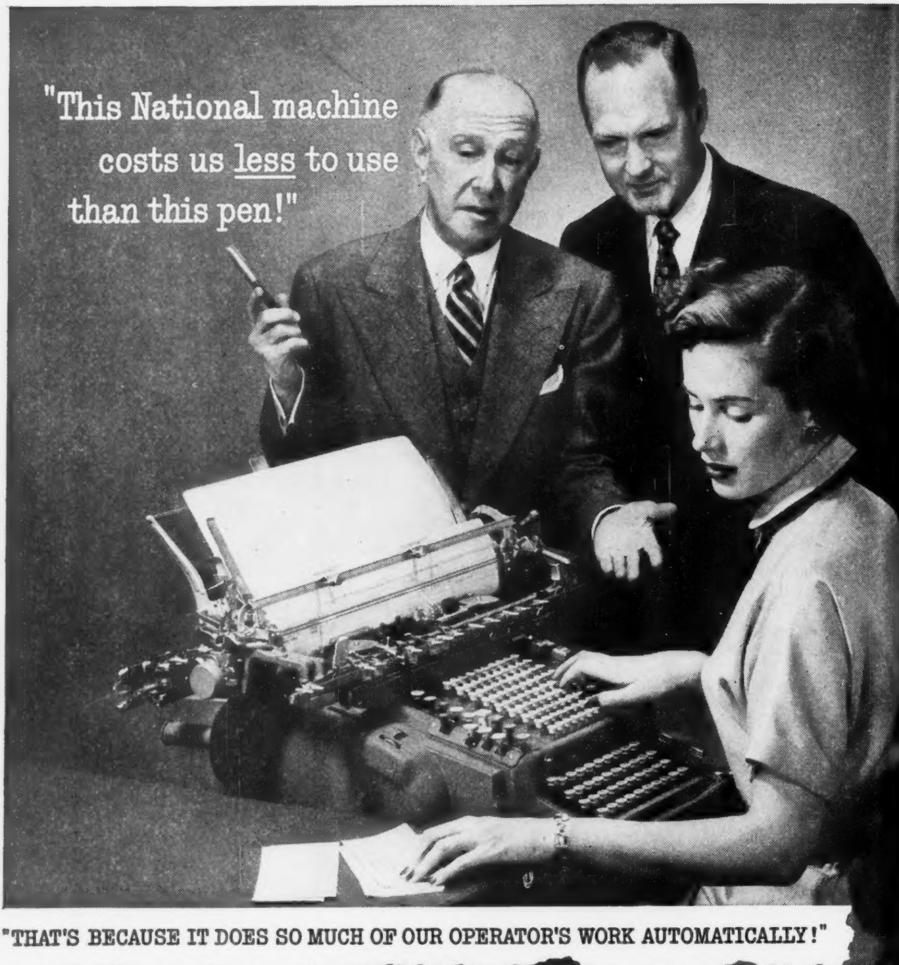

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VOL. XX — *May • 1950* — No. 5

Passing the C. P. A. Examination

By GEORGE E. BENNETT, C.P.A.

A CERTIFIED PUBLIC ACCOUNTANT is licensed as an expert accountant and auditor. By state recognition, he is presumed to be able to perform professional duties at a level considerably beyond that of a junior assistant. It is the duty of the examiners, to the profession and to the public, to see that minimum qualifications on the part of each examinee have been met.

GEORGE E. BENNETT, C.P.A., New York and Pennsylvania, has been a member of our Society since 1922, and of the American Institute of Accountants since 1930. He is a partner in the firm of Evans and Bennett, C.P.A's., Syracuse and Pittsburgh.

Mr. Bennett is a graduate of the University of Wisconsin, with the degree of A.B. He also holds the degree of LL.M., but he is not an attorney. He is a Fellow of the International Institute of Accountants (Australia). He is Professor of Advanced Accounting Practice at Syracuse University, and Chairman of the New York State Board of C.P.A. Examiners.

This paper was presented at a meeting held in Manhattan Center, New York City, March 30, 1950, sponsored by the Board of Examiners and the Society to assist candidates who expect to sit in the coming C.P.A. examination.

Each board of examiners is devoted to doing everything possible to assist a qualified candidate to secure a passing grade in the C.P.A. examinations, keeping in mind, however, that the profession of accountancy must be governed strictly if it is to be accepted by the public as a member of the group of older professions with which all of us are familiar.

The board is for the service use of prospective and actual candidates, and it will treat all fairly and impartially. It is the board's task to administer a public examination in accordance with statute law and the regulations adopted. These emphasize a uniform treatment of all candidates in the public interest, whereby every one is assisted as much as possible to pass the examination. When one has secured a sufficient knowledge of accepted accounting principles and practice, has made a passing grade in each of the examination subjects, he, too, will understand that, generally speaking, only those who have failed can believe the examination to be the most difficult ever devised.

The Examination

The knowledge of a subject that one may have is not synonymous with the mastery of that subject. C.P.A. examinations attempt to measure the mastery each examinee has of the topics included in such examinations. Examiners gauge the degree of proficiency of examinees by the manner in which ac-

quired knowledge is applied to the problems and questions set. Regardless of criticisms, the usual examination accomplishes its purposes more successfully than numerous examinees would have us believe.

An idea seems prevalent that one purpose of the C.P.A. examination is to expose how much or, alternatively, how little, a candidate knows of the theory and practice of accounting. Again, that another purpose is to have the candidate locate pitfalls which are hidden somewhere in the detail of a problem or in the wording of a question. To be influenced adversely by such ideas is certain to cause an examinee to lose confidence in himself. Far better is it for one to recognize that the examination is set to bring out, on the part of each examinee, his latent powers of independent action.

The object of each examination is to prove each examinee in two main directions—in tests of ability and of initiative. Each examination is a means to these ends. Each candidate is confronted with the requirement of furnishing ample evidence that these valuable qualities are possessed.

What is meant by "tests of ability and initiative?" The following illustration from practice should suffice; it also has value in relation to the C.P.A. examination. A young man on the staff of a public accounting firm for some three years handed a firm partner a set of working papers and related statements which he had prepared. From his personal knowledge of the case, the partner noticed that two expense accruals had not been taken up. The staff man was told to "make the necessary adjustments."

The adjustments were made to the extent that obvious expenses were charged and proper accrued liabilities credited, after which the papers were returned to the partner. The adjustments to this extent were correct. However, the partner asked the staff man this question: "Did you adjust the president's bonus, the Federal income tax, and the franchise tax as a result of increasing expenses?" The answer to this question was "No." I leave it to you to decide whether or not this person is or is not senior timber. Would he be one with a good chance of passing the C.P.A. examination?

The problems and questions offered for solution, for the most part, reflect the increasing complexities of modern business accounting. As complexity increases, demanding greater skill and ability, textbooks presumably are revised to meet the situations that result. If educators (and candidates) fail to recognize what actually is going on in the business world, and do not take the steps necessary to meet the changes, the examiners are criticized unjustly if they are taken to task for their recognition of modern tendencies.

A certain candidate who failed in the Commercial Law part of a recent examination told an examiner that the law paper contained eighteen points not mentioned in the text he used in the university from which he was graduated. The failure of that text to provide the proper and necessary information could not by any stretch of the imagination be laid at the door of the examination; the blame lay elsewhere.

Reasons for Failure Summarized

Based upon the results of past examinations, failures have been due to the following causes:

1. Lack of a knowledge of accepted fundamental principles.
2. Granting a knowledge of such fundamental principles, then there is either but little knowledge of application or the failed candidate has not taken advantage of such knowledge.
3. Failure to interpret properly, or failure to recognize some element in the facts given which is vital to preparing an acceptable answer or solution.
4. Closely coupled with the last point is that of not meeting the

requirements of a question or problem, and nothing more than the requirements even when the extra work done would represent acceptable practice.

5. Specific assumptions are made in answer to general questions.
6. Lack of knowledge of business customs and operations.
7. Deficiency in simple arithmetic and clarity of expression in English.
8. Contradiction of what was first stated.
9. Lack of evaluating the time element.
10. Lack of diversified and proper public accounting experience.
11. Assuming the above causes are not responsible for failure, the inability to pass may be due to nervousness.

Even though the above causes may not represent a complete listing, they are sufficient, nevertheless, for a framework upon which to tie the comments and suggestions which follow.

Reasons for Failure Elaborated and Illustrated

The reasons offered for failure in one portion of the examination are generally similar to those which may be given for failure to pass in any other part of the examination. Hence, a strict separation by examination subjects is not considered as necessary in connection with what follows. A thorough knowledge of acceptable principles is an absolute necessity for passing the C.P.A. examination—a little knowledge is a dangerous thing.

Question No. 6, in the last Theory of Accounts examination, for example, related to the retirement method of accounting as frequently "advocated for use by public utility concerns." After advancing some of the arguments for the retirement method, the question required the candidate "to give the arguments against the use of the retirement method or retirement-reserve method of accounting." Many candidates elaborated upon the Federal income tax consequences, basing their answers upon the tax concept rather than upon the accounting concept. If there is a difference between the accounting and the tax concept in relation to a certain matter, the accounting controls insofar as the theory of the mechanism is concerned.

Many moot points exist in accounting and numerous procedures have not yet been crystallized into definitions. However, certain rules and relations are accepted in the business world as being fundamental. Essential knowledge thereof can be secured only by consistent study—by logical study. One should go back of procedures to discover reasons. Next, these should be codified into a logical scheme of principles, that is, of an accepted classification.

If we assume that a candidate has a knowledge of acceptable principles, examination failure may be due either to the examinee having but little or no knowledge of application, or to the fact that he does not take advantage of such knowledge. Given a lack of skill in application, knowledge of principles is of only slight value in professional work. A major purpose of the examination is to offer the candidate an opportunity to demonstrate skill in the application of principles; particularly is this true in Auditing and in Practical Accounting. One failed paper contained journal entries made in reverse order from that in which they should have been set up.

Failure may be due to inability to present such results as are desired or required. There is more to the form of a financial statement than merely setting something down on paper hit or miss, which eventually will reach an answer. Thus, there is something more to an acceptable Profit and Loss Statement than just a string of figures which reflect additions and subtractions, even though the correct answer or result

thereby may be forthcoming; to have such a presentation means disaster insofar as that particular situation is concerned.

Applicants who are employed by large accounting firms in responsible positions, such as seniors and supervising seniors, may fail because their contacts in field audits often necessitate the abridgment of accepted audit procedures and accepted application of accounting principles in the process of preparing information for Balance Sheets and Profit and Profit and Loss Statements to be presented to the officials of the corporations audited.

Long experience in these procedures leads many of these applicants to believe that they have a much broader and valuable indication of accounting principles than the employees of smaller concerns. They carry these ideas of abridgment into the examination room to their detriment. Thus, they do not present acceptable solutions or demonstrate acceptable knowledge in the application of accounting or auditing principles. An example of this was the journal entry drawn up by a supervising senior of a large public accounting firm, wherein he prepared a journal entry for unpaid bills amounting to $30,000, which read: "Debit prepaid expenses and credit liabilities." Another practicing accountant of some years of experience, and a good man, practically speaking, was marked down sufficiently to rate a failure because he would not set up a consolidated goodwill account when preparing a Consolidated Balance Sheet. His comment was that he did not believe in such a treatment and, therefore, did not do otherwise in the examination. These two men came in to the office by appointment to talk over their papers and were thus identified as staff men of experience.

Proper application involves an accurate determination of facts in correct relations, and a presentation of the result by a method and in a form acceptable not only in the commercial world, but as a matter of examination technique. Another chap, by the way, who came in for a conference, told me that an adjustment of less than $20,000 was too small to bother with!

But granting a sufficient knowledge of principles and a possible skill in application, success still may be something to be desired—rather than to be realized—because of a lack of proper interpretation of the situations with which he may be confronted in an examination. Ambiguous questions and problems are a rarity; hence, only in an exceptional instance can "ambiguity" be offered by a candidate as a legitimate reason for failure.

Misinterpretation may be due to a hurried reading of a question or problem, this caused by the urge to get something down on paper as soon as the first sentence or paragraph of factual matter has been read. It may be due to the failure to appreciate the significance of certain modifying words or qualifications. Again, it may be due to making false or unwarranted assumptions, thereby altering the situation.

In one instance, a candidate obtained a mathematically correct solution using a calendar year as a basis, whereas the specific requirement was to solve the problem using the fiscal year as a basis. Again, some one solved a problem on the premise of bonds being redeemed at par, whereas the problem definitely required redemption at a premium.

One serious reason responsible for innumerable examination failures is that the requirements of a question or problem are not met. In one case, for example, the only requirement of a certain problem was to present a Consolidated Profit and Loss Statement from the information offered—nothing was mentioned concerning the preparation of a Consolidated Balance Sheet. Nevertheless, over 90% of the candidates who chose this problem went at the solution as if both statements were required. Needless to say, the credit allowed for this problem did not permit of such a solution. Since the requirement called only for the operating

statement, the grading was based solely on the operating statement submitted.

This matter of giving inadequate attention to the questions and problems cannot be emphasized too strongly. It appears that many candidates hurriedly glance at a question or problem, assume the intent and proceed accordingly. If more time were spent in analysis and in formulating the requirements of an answer or solution before writing it, a smaller percentage of failures would result. The old saying that "haste makes waste" is borne out by a review of the answers to many of the questions recently asked.

The introduction to Question No. 5, in the last Theory examination (the data given being related to the Federal income tax regulations) stated:

> "No reasons need be given to support your answers. List the numbers and opposite each number show the letter that identifies the correct answer."

Any number of candidates listed dollar amounts, letters and amounts and, also, explanatory statements and reasons—all superfluous. In some cases, they indicated a letter and next to that letter a dollar amount which related to a different letter.

Question No. 1, in the last Theory examination, in the (b) portion, read as follows:

> "Explain fully what recognition, if any, should be given to each of the items in preparing a balance sheet."

This question concerned contingent liabilities related to six specific items. Since balance-sheet recognition was all that was required in the answer, just how could a candidate read into the question that detailed journal entries were required? Yet this is exactly what many candidates did: they presented journal entries.

In Question No. 1, of Theory, by answering parts (a) and (b) separately, many candidates tended to become repetitious and to write answers which exceeded in length, and in detail, the relative worth of the question. Many also tended to contradict in the second section of such question, the points they discussed in the first section.

Candidates frequently make specific assumptions in answer to general questions. Question No. 3, in Theory, asked for the arguments for and against inclusion of items which enter into the cost of material acquisition and handling as a part of the cost of raw materials in stores. One candidate stipulated several arguments but they related only to tobacco and liquor inventories.

Candidates too often do not reread their papers to correct grammar, spelling, or the theory of accounts. A candidate in answer to part (2) of Question No. 1, of Theory, which as indicated above related to contingent liabilities, answered as follows (this is quoted exactly as the candidate wrote it):

> "I may be a defendant in a law suit, as such I may contingently liable for said suit. There is that contingent that I may or may not be liable. I wouldn't give any recognition to the fact in the balance or in a footnote. As on judge said that the showing of said contingency in the balance will not be an asset for the firm but would be a liability."

Candidates also contradict themselves, because they do not reread their papers objectively. Another candidate in answer to the same question wrote:

> "Until we are proven innocent in any law suit we must consider ourselves contingent liable for sum or sums unknown. This item has no place on a balance sheet and should not be considered."

Question No. 4, in the last Theory examination read:

> "State whether in financial accounting each of the following items is commonly included in current operations or deferred in some manner. Also explain fully how effectively or ineffectively the usual procedure matches costs with revenue:
>
> a Purchase discounts
>
> b Selling expense
>
> c Plant rearrangement costs"

Numerous candidates indicated, as an answer, a suggested treatment on a Profit and Loss Statement. In discussing the item of purchase discounts, many elaborated upon sales discounts,

terms of discount, etc., which presentation was not required or desired by the examiners.

Candidates frequently make general statements against the position they have argued. For example, in answer to Question No. 4, in Theory, (just mentioned above) one candidate wrote the entire answer, presenting complete arguments for the position he took and then he made the following statement:

> "In all of the above expenses or revenues the theory should be followed that costs incurred in producing a certain income should be charged against that same income unless impractical or other influencing factors arise."

Candidates frequently do not properly evaluate time and worth of questions. They often write as lengthy an explanation for a 2½ point section of a 15 point problem, as they will write for an entire 15 point problem. This generally happens when they are thoroughly familiar with the topic to be discussed. Instead of answering only the major points called for, they attempt to discuss all phases of which they have knowledge.

Some recent answers in auditing contained the phrase: "Check with management," or "check with officials," leaving the assumption that that, in itself, is a verification. In some instances such a step is a part of the program, but if there are other sources more original, they also should be referred to in the answer.

Many answers to a recent auditing question contained the phrase "he should ascertain," without outlining the method of ascertaining the information desired. It is of no use to say: "He should ascertain that the inventories are properly priced," without at least indicating the procedures to be followed.

Again, in answer to a question to present in outline form a complete audit program such as would ordinarily be followed in the verification of the finished goods inventory of a manufacturer, the only reference to the physical inventory was "if possible, have all physical units counted or verified; otherwise test check." Such a statement as this is not adequate with regard to the program for a physical test check, and it leaves the impression that the candidate does not know the steps to be followed. If he does, then he hurts himself by such a generalized statement.

Question No. 2, in the November Auditing examination stated:

> "List and give briefly the purpose of all audit procedures which reasonably might be taken by an auditor to determine that all fixed asset retirements have been recorded on the books."

The number of candidates who gave a detailed program for the verification of fixed asset additions, making little or no reference to retirements, was unbelievable. Many answers indicated that the audit steps necessary to verify fixed asset additions were known, but a failure to read carefully and grasp the import of the question was most evident.

In connection with another auditing question in the November, 1949, examination, some candidates apparently did not read carefully the explanations concerning the items of prepaid expenses and deferred charges. For example, bond discount was stated to be $5,000, and it was explained parenthetically that "this represents the discount on $200,000 of 3% 20-year First Mortgage Bonds sold January 2, 1947." Some candidates computed the bond discount to be $6,000, arrived at by taking 3% of $200,000. Assuredly, these candidates, had they concentrated on the explanation, would not have made such an obvious error.

In the same question reference was made to flood damage. One paper in stating the procedure to be followed in the audit of the flood damage, stated "flood damage—check with officials as to what damage was incurred. Check with supervisor as to the damage incurred to their equipment. I would try to tie in the amount of $4,765 which was charged." An answer of this type is most confusing and does not include audit steps. The candidate stated that

he would try to tie in the amount which was charged, but he did not indicate to what he would tie it in with—perhaps the tie in was to be with the kitchen stove.

Another November, 1949, audit question asked for the preparation of an audit program for the verification of the reserve for product guarantees. In answer to this, one candidate wrote, "confer with management as to the adequacy of the amount and obtain a liability certificate from them." The answer contained no other procedures to be followed in determining the adequacy of the reserve. If auditing were as simple as this answer would seem to indicate, there would be no need for all the work, study, and effort now spent in the examination of financial statements. As a matter of fact, auditors would be unnecessary where management gave a representation as to the financial statements.

One November, 1949, question referred to the audit procedures in the annual audit of a large transient hotel. The word "transient" did not seem to mean anything to many candidates because they gave the procedures which would be followed where the hotel rooms were rented largely on a yearly basis.

Assume, next, that a problem is offered which calls for the preparation of a work sheet—the requirement is "prepare a work sheet." It is a waste of time and effort in such case to prepare a schedule of adjusting entries and then to post to the work sheet. The requirement calls for a work sheet, not for a schedule of adjusting entries; the latter may have some value to the candidate but, nevertheless, from the examiner's point of view it is surplusage not worthy of being given credit.

While on the subject of work sheets, from an examination point of view, the adding up of the adjustment pair of columns is a waste of time until you have discovered that the statements set up thereon do not balance out. It is suggested that, in your study of problem solutions, after a work sheet has been prepared, attempt a shortening up or condensation of the form which has been used. Time and again the elimination of a column or of a pair of columns is possible; it may even be that the use of a work sheet is unnecessary—provided the problem requirement does not call for the preparation of one.

Only recently I had occasion to examine the solution of a recent uniform examination problem. It contained a work sheet on which one column was absolutely unnecessary and which, so far as the solution was concerned, would have required from ten to fifteen minutes on the part of a candidate to build up. Some years ago, the uniform examination contained a problem calling for an adjusted Statement of Surplus, the period of time covered being three years. I have seen three different methods of solution for this problem. One used an elaborate work sheet which started at the left with a column for the unadjusted balance at the close of each year, followed by columns for profit and loss and closing surplus, respectively, for each year of the period—thirteen columns in all, exclusive of space for a listing of the accounts. Another solution used a form of work sheet containing ten columns for the amounts involved. The third provided an excellent setup without using a work sheet; this form would consume not more than one-third of the preparation time that the first form would require. Naturally, the third method could not be used unless one had an excellent working knowledge of the effect of the usual year-end adjustments as they affect the result of each of two years; however, an examination candidate ought to have such a knowledge.

Considerable time may be saved in preparing a work sheet for a Consolidated Balance Sheet by beginning with a "total" column, thus not having it necessary to copy on the sheet the detail for each company. All one needs to do is to separate the interrelated company elements when writing in the account

names. A careful reading of the problem should permit this to be done.

Suppose that a problem is encountered which calls for the preparation of a Balance Sheet and a Profit and Loss Statement, and that numerous adjustments are required so that a work sheet is necessary. The following suggestions as to preparation are offered:

1. Use a separate sheet for the Balance-Sheet accounts and a separate sheet for the Profit-and-Loss accounts. If the Profit-and-Loss accounts are so numerous that they will spill over on to a second sheet, then separate by groups, so that a complete group is placed upon one sheet.
2. Decide upon the statement headings you expect to use, and arrange the accounts thereunder in the approximate order in which you expect to have them appear in the completed statements. Thus, the final columns at the right of the sheet for the Balance Sheet and for the Profit and Loss Statement will be organized approximately as these final statements in technical form should be prepared.

The reason for this method of attack is merely this: If you are pressed for time, do not attempt to prepare the statements in technical form. Leave the work sheet, when thus completed, and move on to the solution of the next problem. Later, time permitting, go back and prepare in technical form the statements called for; probably in this connection you will be copying exactly what you have in the final columns of each sheet. I am not saying that, as a result of such a procedure, you will secure as high a grade for only the work sheet, as you would if formal statements were offered. Nevertheless, if the work sheet outlines the form of an acceptable statement, it is difficult for me to believe that a fair-minded examiner will mark down severely to the point that failure by this means will follow.

Suppose that you were confronted with a problem which contained a trial balance that did not balance—total debits not equal to total credits. Just what would you do upon discovering such fact? Would you immediately make the life of the person in charge of the examination room miserable with condemnations of the examination, or proceed with the solution of the problem based upon the facts as given? Perhaps an error may have crept into the problem in the printing of it—this is doubtful; perhaps the problem was offered in that form just to find out how you would meet the situation. At least it would be a proper approach to go ahead with what was offered, prepare your solution, and indicate how you treated the situation in view of what was discovered. Should an error be present, this will be known by the examiners before the grading is begun, and proper adjustment made for such fact in the grading.

Some time ago, a problem was offered in an examination which took a competent author of a published solution twice as long to present his results as the allotted time for the entire paper (I have this on good authority). And this was not the only problem in that particular paper required to be solved within the period assigned. What would you have done under the circumstances?

The gentleman who was the outstanding successful examinee in that examination was a roommate of mine back in university days. I asked him just what he did in preparing his solution to this particular problem because, although I believe that I am and have been familiar with the type of enterprise to which the problem was related, it took me more than the credit point time to solve this problem in a reasonably complete manner. His answer brought out the following worthwhile points:

1. After reading and studying the

problem, he realized that a complete solution was impossible within the given examination period, if he were to solve all parts of the problem.

2. Study of the problem convinced him that it contained three or four elements which were the important ones, and which could be worked out within the time allotted to the problem.
3. These elements were worked out, and set into the required statements in their proper positions, the statements being presented in skeletonized form.

How many of you here this evening would have adopted this person's method of attack, rather than proceed like a plough horse to whom time meant nothing, offer a partial solution that would not recognize the salient factors involved and, later, deluge the Board of Examiners, et al, with protests of unfairness? It is no wonder that this person became a partner in one of the large accounting firms, and resident manager of its second largest office.

If the securing of a C.P.A. certificate is the hall mark that indicates the holder is a capable accountant, then problems of that type are not unfair. Frequently, in practice, we are up against a dead-line which makes it mandatory for us to separate the essential from that which is not so essential, no matter how usable the latter may be, so that a satisfactory report may be issued.

Numerous papers reflect clearly the lack of experience on the part of candidates. Examiners cannot limit the problems to what is the practice in any one particular professional office.

The ambition to become a C.P.A. too often is not accompanied by the will to work and to wait. Generally speaking, candidates are in too much of a hurry to take the examination—the examination is considered as being perfunctory. In the last analysis, preparation is up to the candidates. Teachers may help, may guide; they cannot do the preparation for them. Preparation implies study, study, and more study; as to this there should be no stopping. In fact, preparation should begin at the time a person decides to take up public accounting and continue until he or she gives up public accounting. Such a procedure eliminates cramming; the results of cramming are dire.

A problem presented for solution calls for the same mental activity as does an actual audit. One should not rely upon memory as a substitute for actual knowledge of principles and practice. A memorized solution based upon the expectation that a certain problem, or type of problem, will be given in the coming examination represents wasted energy. Resemblances do show up, but they will be superficial and, if too much reliance is placed thereon, one goes off on the wrong track.

Actually, it is not going too far afield to emphasize the fact that a large amount of practice in solving problems, and in answering questions, is necessary. If one is connected with a small office, problems and questions taken from books and from other publications should be worked and answered in order to secure a varied coverage. Those attached to a large office should not neglect this method of preparation.

When the solution of a book or magazine problem is attempted, actually work it out without referring to the author's solution should the latter be available. Stay with the task of solution even though it may take a week of spare time to complete it. Do not consider yourself satisfied with what you have done until you reach a point where you cannot improve upon your solution. Then, and only then, if available, compare your work with that of the author. If you disagree with the author, ascertain why; authors have been known to be in error. Take nothing for granted; a good auditor does not do so. He works to a logical conclusion and then checks himself.

In the period of preparation prior to an examination, the candidate should review various types of questions and problems, deciding which for him are the most difficult. He should spend enough time on those of each type so that confidence in their solution and answer is forthcoming, rather than to skip any in the hope that in the examination a question or problem related to one of those doubtful categories will not be encountered.

Another common type of error is not to review the types of problems on which work is constantly being done in every-day practice. Numerous petty idiosyncrasies are practiced by firms and by individuals, which do not conform strictly to acceptable accounting principles as set out in the pronouncements of the American Institute of Accountants, and by recognized authors. For example, many accountants treat cash discounts received on machinery purchases (fixed asset purchases) as other income whereas accepted principles treat such discounts as a reduction of gross purchase cost.

A person should not be in a hurry to enter the Practical and the Auditing portions of the examination. Statistics over the years have proved to our Board that the greatest success in passing the examinations is by those who have had between three and four years of diversified practical experience. A good junior cannot be developed under six months, assuming satisfactory working conditions. It may take from three to five years to develop a competent and qualified senior accountant.

If one grows impatient by waiting, he should read the published reports of large corporations, and attempt to visualize the extent of the work required and the responsibility involved, in certifying such reports. It is believed that every year of waiting (at least up to a total of three years) betters a person's chances of passing the Practical and Auditing portions of the examination.

Assuming that failure in the examinations is not due to any of the elements mentioned above but that failure is met with, the reason therefor may be nervousness. The examination promotes a nervous strain which, generally speaking, is not encountered in ordinary practice. One approaches professional work as master of the situation, whereas the same person is apt to approach the examination with awe and uncertainty.

A case of nerves is a common ailment. To avoid this, tackle something easy first, to establish composure. The easy situation "nailed to the mast," the candidate becomes happy (and justifiably so) in the conceit that at least one aspect of a vast subject has been mastered. The taking of an easy problem first, for example, demands only easy mental effort which, in turn, reduces the condition of flurry and creates a sense of confidence and control. By picking an easy problem first, one is able to accelerate the working of his mind, so that later when he has to tackle a hard problem—one which on first thought was difficult—the chances are excellent that such a problem does not appear to be difficult. Confidence is thus established at the start.

The view, rather well established in certain quarters, that a heavy problem should be taken first, it is believed, is wrong; such an election may lead to disaster, whereas the other approach may not. Unless tension is reduced, it is impossible to deal with a problem containing much detail work without the risk being present of "muddling" which, in turn, increases loss of confidence in one's ability to succeed in the test. If a candidate begins his work with a difficult problem, he may never have time to tackle those that are easy.

One young man, now certified, did exactly this in taking his first examination in Practical Accounting. His solution of this one problem was complete, and perfect, and received the maximum grade allowed therefor. But he had nothing else on his papers—and failed.

Approach the examination as if you were going out on an important engage-

ment on which you have to do all the work by yourself. Budget the time that is allowed. Take at least fifteen minutes studying the questions and problems and deciding the order of answer or solution. Then pick the first question or problem, as the case may be, that seems to you easy of solution.

Read the question or problem selected carefully—do this twice, at least. Ask yourself questions along the line of what you would do if up against the same situation in practice. Check or underline each word or phrase that has a bearing on the result but which might be overlooked.

Many years ago, a member of a certain examining board who had had years of experience was asked this question: "If you were given an hour within which to solve an accounting problem, and your life depended upon preparing an acceptable solution, just how would you budget your time in setting up your solution?" The answer was brief but to the point: "I would spend fifty minutes reading and studying the problem and requirements, and ten minutes in putting the solution on paper."

Use pencil in preparing working papers; use ink in preparing final statements and answers to questions. Use separate sheets for each answer or solution. Sort the papers in proper sequence later. Fasten the sheets of each solution together with a paper clip until all are to be brought together. Then use the staple that is furnished. Give each solution and answer the number assigned, and number each sheet. Be sure that the staple pierces all sheets. Fasten all sheets so that the examiner's time is conserved, and so that they may be opened readily.

Budget your time so that there will be approximately one-half hour before the close of the allotted examination period for relaxation and review. Use at least five minutes for relaxation; forget everything because the brain needs rest. The rest completed, a mental freshness results which may prove most valuable when reviewing the work completed.

Work done at high speed encourages errors. Frequently, a solution or an answer, as set down, upon review, will contain something never intended; therefore, time should be provided for review.

Make certain that all "required" problems and questions have been solved or answered, as well as those extra ones needed to complete the paper. One may be tempted to be satisfied in working out, say, 80% of an examination in the belief that this will be sufficient to secure a passing grade of 75%. This attitude, however, may be in error, and usually is, since if the examiners do not agree that the worth of the paper is 75%, failure is certain. A leeway of but five points may not be sufficient to have the given grade pushed up to the passing mark.

In conclusion, take the examination with a smile. Remember the examination is provided to prove the candidate's mastery of the subject, not to expose lack of ability. Therefore, study to be master of the situation.

Preparation for the C.P.A. Examination

By Robert L. Kane, Jr., C.P.A.

The primary responsibility for preparing the uniform CPA examination rests on the board of examiners of the American Institute of Accountants. However, in the actual work of preparation, the board obtains the advice and assistance of a great number of accountants.

The board of examiners is elected by the council of the Institute. There are nine board members representing various sections of the country. While at present there are three members from New York, there is no geographical concentration of members. Four of the nine members, in addition to public practice, have had experience teaching accounting in college.

The examination preparation can be divided into several steps. First is the collection and preparation of basic material to be used in the examinations.

There are four sources for obtaining examination material. A considerable amount is obtained from accounting firms and individual practitioners. Not only are specific requests sent to accountants asking for examination material, but they are encouraged to send in material at any time they encounter interesting problems in practice. The second source consists of the members of the various state boards of accountancy. Several state board members regularly contribute material. The third source is the teaching profession. Potential examination material is sometimes obtained direct from schools and also from time to time teachers are engaged to prepare a specific amount of material. For example, a teacher may be employed to prepare ten questions on auditing. The fourth source develops from the employment of teachers or others on a salary basis to prepare material. This method is usually utilized to fill in the gaps in existing material by preparing questions or problems in a specific area.

The material obtained from the first three of these sources goes into the "stockpile" of material for the various subjects. It may or may not be in form suitable for use in an examination. Even at best it will ordinarily require some revision before it finally appears in an examination. The selection of the material that will go into any particular examination is based on several factors.

It is the purpose of the board to have each examination contain as wide a coverage of material as is possible, but, since it is impossible to cover all topics in each examination, a schedule is maintained which lists the various areas to be covered, and upon these schedules the examinations are plotted. A fixed scheme of rotation would not be useful because its regularity would be detected

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This paper, which was presented to prospective CPA candidates at a meeting on March 30, 1950, sponsored by the New York State Society of CPAs and the New York State Board of CPA Examiners, describes the general procedures followed by the board of examiners of the American Institute of Accountants in preparing the uniform CPA examination. The procedure followed in the collection of basic material and the method of determining the areas covered by a particular examination are described.

by some persons who would thereby have a considerable advantage in preparing for the examination, and for whom the examination would not then be a fair test of knowledge and ability.

When the areas to be covered have been selected, the material in the stockpile is reviewed to select that which is appropriate. To the extent that material in any area is lacking, someone is employed to prepare the needed problems or questions.

Since you will probably find the classification of examination areas to be very interesting, I will consider them in some detail.

A complete separation of material included in Accounting Practice, Theory, and Auditing is not possible. The distinction between the three subjects is likely to be more in the manner of the approach rather than in coverage. For example, Practice usually involves making computations and arriving at a numerical answer, whereas Theory involves an exposition of a theory, or of a practice, and probably a statement of the reasoning which supports the theory. Auditing may be concerned merely with techniques used by the auditor or it may combine techniques with questions involving the application of accounting theory.

In classifying the area covered by Accounting Practice and by Theory, we find three large areas (each of which may be subdivided) and a great number of smaller areas. These three large areas are Income Taxes, Cost Accounting, and Fund Accounting. All recent examinations have included at least one problem or question on some part of each of these three areas and frequently more than one has been included. There are perhaps as many as 50 of the smaller areas that appear from time to time in the examinations.

Examples are:

1. Application of fund statements
2. Analysis of statements
3. Appraisals
4. Budgets
5. Bank accounting
6. Brokerage accounting
7. Balance-sheet form and presentation
8. Bookkeeping errors
9. Bond transactions
10. Bad debts—accounting for

Such relatively small areas as these have usually made up most of the examination. They have appeared with varying frequency and no regularity in their occurrence has been detected. I feel sure that the board of examiners does not intend to have them appear with any predictable regularity.

It appears that the classification of questions in Commercial Law into large areas is easy. Such areas as Negotiable Instruments, Contracts, Sales, Agency, Corporations, Partnerships and Bailments appear on almost every examination. Some of the other areas that are included at various times are: Bankruptcy, Insurance Trusts, Common Carriers, Estates, and Real Property.

After the examination areas and materials are tentatively selected, each part of the proposed examination is then reviewed, first by a sub-committee of the board, and later by the entire board as well as by some other interested parties such as members of state boards. Numerous suggestions for additions, deletions and changes usually result from these reviews. During the time this review is taking place, the examination material is "guinea-pigged." By that, I mean that each part of it is actually worked out by at least two CPAs who have had considerable experience in grading papers. They work through the examination to determine the length of time required to give satisfactory answers; to determine whether the questions and problems are ambiguous; and to determine whether the material included seems to constitute a reasonable examination in the subject. Normally, the examination will be reduced in length to where the time these men require to solve it is not more than

two-thirds to three-fourths of the time allowed for the candidate.

After these procedures are completed a revision of the examination is prepared and reconsidered by the board. If it then meets with their approval, a final test of the examination is obtained by having several recently certified men take the examination under actual time limits.

The entire procedure that I have described takes a great amount of time. Examinations for November are even now being considered by sub-committees of the board. The purpose of the procedure is to be certain that a comprehensive but reasonable examination is prepared. Certainly it is the intent of the Institute's board of examiners and of the various state boards to give an examination that is a reasonable test of the candidate's ability in the accounting field, and one that can and will be passed by a well-prepared candidate who has the aptitude and ability that is necessary for practice as a certified public accountant. The examination you will take has been reviewed by a number of people to determine that it is fair and reasonable, and each part of it has been actually tried out on at least three people to determine that it can be satisfactorily solved in the time allowed.

Audit of Accounts Receivable

By John F. Schmonsees, C.P.A.

Before discussion of procedures involved in an audit of accounts receivable, it may be well to state what the objectives of such an audit should be and to list them in the order in which they occur to one who recognizes this audit as an important phase of the verification of income, and not simply as the substantiation of an asset. Assuming that an examination has to do with the affairs of a manufacturing company and is made for the purpose of expressing an opinion as to the fairness of financial statements of the company, the auditor in his procedures relating to accounts receivable will seek to satisfy himself:

1—That all goods shipped during the period under review have been charged to customers;

2—That all credits to customers during the period represent either:

a—Cash received,

b—Goods returned or allowances made under proper authorizations,

c—Discounts allowed in accordance with terms of sales, or

d—Write-off of balances considered uncollectible—on proper authority;

3—That customers' balances at the balance sheet date represent valid obligations of real debtors—that they are authentic; and

4—That the valuation of the receivables and provision for uncollectibles at the balance sheet date and the description and classification of accounts on the balance sheet are fair.

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With these objectives clearly in mind, the records and documents to be examined or tested and auditing procedures required may be considered.

The auditor may work toward his first objective—determination that all shipments during the period have been charged to customers—by tracing the detail of the chronological shipping record to the sales register through the medium of copies of sales invoices. Totals of the sales register will then be traced to charges to the accounts receivable ledger control. Thus, the shipping record will be related to charges to customers as directly as is possible. Any debits in the control account not traceable to the sales record should be thoroughly investigated.

The second objective—determination that all credits to customers during the period represent cash collections, properly authorized returns or allowances, proper discounts, or authorized write-offs—will be sought by tracing credits from the accounts receivable ledger control to the cash receipts journal and to whatever journal may be used to record returns and allowances and write-offs. The validation of the cash receipts journal to this purpose will be done as part of the audit of cash transactions, so that we will not discuss further the audit of collections and discounts. Credit memoranda will be scrutinized for proper authorization in support of the journal record of returns and allowances, and returned goods will also be traced to receiving records. Any other credits in the ledger account will be thoroughly investigated.

At this point, the amount of the ledger control balance at the period's end will have been established as a reliable representation of the total accounts receivable, insofar as the records of the company can give assurance of reliability. However, it has not been established that all collections which

should have reached the company have been received and recorded, or that the amount shown by the ledger control represents a fair valuation of the receivables. Assurance as to these matters as well as additional evidence of the authenticity of the accounts will be the next two objectives, for which the auditor will prepare by listing or requesting the client to furnish a list of individual accounts receivable balances as of the period's end from the company's ledger. He should assure himself that the list total agrees with the accounts receivable ledger control balance.

The third objective—determination that receivable balances represent authentic debts—will be sought first by direct communication with debtors (which is mandatory under "Extensions of Auditing Procedures") to obtain confirmation of the amounts of the debts. When it is neither practicable nor reasonable to use this procedure, and then only, the auditor should, as an alternative, seek evidence of authenticity by reference to records of subsequent payment and to any relevant documentary matter in the company's files which originated outside the company under examination, such as delivery receipts, bills of lading, and correspondence with the customer.

The fourth objective—formation of opinion as to the fairness of valuation, and description and classification on the balance sheet—will be sought by: review of the list of outstanding accounts receivable at the balance sheet date; discussion of the histories of accounts and probability of collection with responsible executives; reference to subsequent records of payment and of returns and allowances; and examination of records relating to the customer's credit standing.

The summary of audit procedures just set forth aims to give in simple terms the logical order of an audit of accounts receivable. Such an outline may serve as a standard against which the effectivenes of procedures actually used in an audit may be measured. Circumstances will often dictate or permit some departure from our outline and, in any case, will determine the extent to which procedures should be applied. Let me illustrate the point I am trying to make. We have said that it should be determined that all shipments made during the period under review were charged to customers, and have pointed out that the auditor will usually satisfy himself on this matter by tracing details of the shipping record through the sales journal to the accounts receivable control. That is an ideal procedure. However, in many cases, no shipping record is maintained and the only available starting point in this phase of his audit is a file of sales invoices. The auditor will know that the record of sales, in itself, is not a satisfactory basis for his purpose. He should commence with shipments but has no record or no satisfactory record of them. Nevertheless, a study of internal control may disclose controls surrounding shipments sufficient to give reasonable assurance that no shipments can be made without the preparation of a prenumbered sales invoice, and the auditor may be able to determine that all invoice numbers have been accounted for as a regular internal procedure. In such case, the file of prenumbered sales invoices may be accepted as a record of shipments and as a proper starting point toward his first objective. On the other hand, it may be impossible for the auditor to satisfy himself from either shipping or sales records that all shipments have been charged to customers. Even in such case, however, he may be able, by some over-all method, to obtain reasonable assurance that substantially all shipments have been charged to customers. This might be accomplished in some situations by a comparison of production and inventory units with sales units. Often, however, the auditor must face up to the impossibility of determining that all goods shipped have been charged to customers.

Audit procedures have been outlined in the foregoing without mention of the

effect which satisfactory internal control would have on the extent of their application. In practice, where satisfactory control exists, an auditor may limit many procedures to a sufficient test to assure himself of its existence and effectiveness. Even in cases in which internal control is less than adequate, extensive tests may be all that is required to satisfy the auditor as to certain of his objectives.

The auditor's procedures may be presented now in greater detail. The same general order will be followed as was used in citing objectives and in summarizing records and procedures.

Let us turn again to the first objective, determination that all goods shipped during the period have been charged to customers. Procedures leading to this objective have already been discussed in some detail as an illustration of an earlier point. I should like to observe that in cases in which no reliable record of shipments is maintained and internal control in respect of shipments is lacking or unsatisfactory, the way is open to the shipment of goods and collection of proceeds without either a sale or receipt appearing in the accounting records. Furthermore, in such a case, it is usually difficult to compensate for the lack of records and control by extended audit procedures. On the other hand, where satisfactory internal control of shipments exists, auditing standards are usually met by a limited test of the shipping record to the sales register.

The second objective is determination that all credits to customers during the period under review represent cash collections, properly authorized returns and allowances and write-offs, or proper discounts. Procedures leading to this objective relate to entries in the accounts receivable ledger control. In the case of cash collections, they consist merely of checking totals in the accounts receivable control account to the cash receipts book. As an incident of the audit of cash receipts, these will be traced to bank deposits. Cash discounts should also be traced to the cash records. The propriety of cash discounts will also usually be determined as a part of the cash audit program. Returns and allowances and other credits, such as write-offs, remain for our attention. Authorizations for these should be inspected and their propriety established. Authorizations should be by persons formally designated to have such authority. When examining authorizations, the auditor should seek to determine that the approval is that of a person not having access to cash or merchandise. If assurance on this point is lacking, additional evidence of the propriety of credit entries should be sought. With respect to allowances, correspondence with customers may be available, and returned merchandise may be evidenced by receiving reports or correspondence, or both. When doubt is sufficiently serious, the auditor may be justified in seeking confirmation directly from the customer. Other credits to accounts receivable should receive careful attention by the auditor. An instance will be found in the write-offs of bad debts. Here again authorization should be examined and consideration given to the validity of the approval. For example, the credit manager should not ordinarily be the sole authority for write-offs because it might be to his interest to withhold the attention of his superior from examples of unjustifiable allowances of credit. If internal control of receivables, returns and allowances is satisfactory, the audit procedures directed to credits in the receivable control will usually be limited to a test sufficient to demonstrate the effectiveness of internal control.

In closing comment on the audit of credits to accounts receivable control, let me emphasize that the mere fact of approval by a responsible officer or employee of the company is not necessarily itself sufficient. The auditor must be satisfied that the approval is not that of a person who could personally profit by passing improper credits. That is, the person approving a credit should not,

for example, be in position to abstract cash without detection and cover the withdrawal by a false credit to a receivable, ostensibly representing an allowance. When assurance is lacking as to the disinterestedness of the approving person, procedures should be sought which by-pass such an individual.

The next two objectives relate to the unpaid receivable balances, the total of which is carried on the balance sheet as of the end of the fiscal period. In preparation for carrying out audit procedures directed to those objectives, the auditor will prepare or, as in most instances, request his client to prepare a list of customers' balances as of the balance sheet date. The list should be arranged so as to serve a number of uses, including the review of balances with the credit manager or other executives and, later, with a principal of the auditor's firm. For these purposes space should be provided for ageing balances and for notation of all information relating to the status of accounts. Actually the listing should be arranged so as to show the age of balances, that is, the portion not past due and degree of delinquency on past due portion.

The total of individual balances should be compared by the auditor with the balance in the accounts receivable ledger control and, if a difference exists, the reconciling items should be noted with a clear and full explanation of the differences, together with a note of the audit steps taken to assure the auditor that acceptable reconciliation has been achieved.

The work sheet under discussion may also provide for notation of collections made on individual accounts subsequent to the balance sheet date. It may serve as a control list of confirmation requests mailed. Finally, it may indicate the classification of the receivables on the balance sheet if they enter into several classifications there.

One more note in connection with the preparation of the list of individual balances. If the list is prepared by the client, the auditor should check it with the ledger. Much information can be taken from the individual ledger accounts at the time that the balances are taken off or checked. For example, credit limits or other information is frequently noted on the customer's account card or sheet. Notations of payments subsequent to the balance sheet date may be made for later tracing to cash records. Time will be saved if information sought from the ledger account is all taken off at one time instead of reviewing the accounts as each type of information is needed.

The third stated objective of the audit procedures, determination that receivable balances represent authentic debts, may be discussed next. It has been explained that this objective will be sought first by communicating directly with the debtors. This procedure, when effective, is presumed to afford the maximum assurance that the receivables are valid obligations of real debtors with respect to items which are still unpaid at the time of audit. We need not enter into the advantages and disadvantages of positive confirmation as compared with the negative form, but may assume that in many cases the auditor will use the negative form at least in respect of a portion of the accounts. The remarks which follow are restricted to positive confirmations because most of the auditor's problems relating to confirmation arise in the use of that type. Let us now consider carefully just what assurance we gain from a satisfactorily completed confirmation and, perhaps just as important, of what we are not made certain. First, confirmation gives assurance as to authenticity, as we have already pointed out. In the second place, it provides some evidence as to the value of the receivable. Though a debtor probably will never admit that he will not pay a just debt, he may state that he has unpresented claims for allowances and that statement would be of importance in appraising the value of an account. Confirmation of accounts also provides assurance that the total of credits due to a customer has been credited to his

account, but it cannot give assurance that the details of the credits have been properly recorded. For example, a customer may have settled an earlier invoice by a cash payment of $900 and the return of merchandise which had been billed at $100. The settlement, however, might appear on the records as cash of $800, returns of $100, and an allowance of $100, and the incorrect entries might have been made to cover a $100 defalcation. Confirmation of unpaid balances will not disclose such a situation. Request for confirmation might disclose the failure to bill a customer for merchandise shipped, but would not do so unless the customer drew attention to the incorrectness of the balance as stated. Finally, because requests for confirmation are only related to open balances, this procedure will not serve to disclose a case in which neither billing nor collection has been recorded as to a completed transaction. These things may be too obvious to require statement, but my purpose is to point up the necessity for additional audit procedures. Confirmation is in itself not merely a supplementary procedure, nor is it an alternative for one or more other procedures. Confirmation by a customer is, however, the only way by which the auditor can be assured that all credits due to the customer up to the balance sheet date have been recognized on the records, and it is the best means of establishing the authenticity of accounts. On the other hand, it can give no assurance that accounts have not been wrongfully manipulated with respect to transactions closed out prior to the statement date.

Having considered what may and may not be accomplished by the confirmation of customers' balances, we may now proceed to a discussion of the methods of procedure and some serious problems which arise in connection therewith.

The organization of requests for confirmation is relatively simple and requires only special care so that exclusive control of requests and replies are kept in the hands of the auditor. Whether the auditor requests confirmation from all debtors or from a selected test section or lot, his greatest problem is that which confronts him in securing an adequate number of replies. One test of adequacy of response to positive confirmation lies in the ratio of replies received and the dollar amount represented by those replies to the number and dollar amount of the balances for which requests were sent to the customers, and in the number and character of differences disclosed by replies received.

To illustrate this statement, let us suppose that the auditor in a 100% confirmation effort has received replies to 60% of the number of confirmations requested and that the dollar amount represented by the replies is 85% of the total amount of the receivables, which was $200,000. Let us also suppose that differences disclosed by the replies caused adjustments to the accounts in a total amount of $2,000. Now, I shall not make any judgment of my own on this hypothetical case, because I do not think that we have as yet settled upon any standards as to what may be considered acceptable or not acceptable, but I will say that I believe that these results would generally be considered satisfactory. On the other hand, let us suppose that the auditor has received replies to 65% of the number of confirmations requested and that the relative dollar amount is 75% of the total amount of the receivables which was again $200,000. We shall also suppose that a great many differences disclosed by these replies caused adjustments to the accounts in an aggregate amount of $16,000. It seems to me that in such case the auditor can only conclude that undisclosed differences in the unconfirmed accounts might be substantial. Moreover, he might also conclude that there is greater probability of differences with the unresponsive debtors than with those who reply. In the latter case, the auditor should intensify efforts to obtain a more complete response to

his requests and, at the same time, carry out all alternative procedures at his command including identification of payments received subsequent to the date of the balance sheet with the receivables at that date, and examination of correspondence and any other documentary matter which might provide a measure of assurance in the cases where confirmation has not been completed.

When the auditor decides to apply the confirmation procedure to a sample of the receivables, rather than to all accounts, intensive efforts must be made to make a complete and satisfactory appraisal of the accounts. This is necessary because the adoption of sampling implies that the conditions found in the sample will be considered as representative of the whole. Therefore, a relatively small overstatement of the accounts in the sample might indicate substantial overstatement of the total. Special investigation of all accounts in the group selected as a test, for which satisfactory replies are not received, is imperative but it is held by some accountants that nothing less than a one hundred per cent response is satisfactory.

One more word about requests for confirmations, before alternative procedures are considered. I believe that more satisfactory response will be made to the first request, in some instances, if care is taken to furnish the customer with information needed by him to identify the amounts on the statement. I refer particularly to customers of the client who keep no accounts payable ledger. Many large corporations and national organizations with branches will confirm balances if order and invoice number are given for each open item but will not do so otherwise. The auditor will be able to determine which customers are apt to require such information, and save time and effort by furnishing it in advance. Some Government departments and agencies will respond if given sufficient information.

When efforts to obtain replies from debtors in response to requests for confirmation have failed or when it is impracticable or unreasonable to attempt confirmation, it is necessary to adopt alternative procedures. Conclusive evidence of the authenticity of an account is payment of the account. Therefore, the auditor will turn to the record of payments received subsequent to the balance sheet date as the first alternative to confirmation. In carrying out this procedure the auditor will satisfy himself as to two things—first—that the record used is genuine and reliable — and, second — that the payment shown by the record does in fact relate to the receivable balance for which verification is sought. The auditor may rely upon effective internal control as to the first requirement. Without such assurance, it might even be necessary to see customers' checks as received or to obtain duplicate deposit slips direct from the bank. As to the second requirement, it is not enough to see that payments have been received from a customer in an amount sufficient to cover the balance under examination. Such payments may be in settlement of invoices rendered subsequent to the balance sheet date, and the balance with which the auditor is concerned may be a disputed or disclaimed amount. It is necessary that the auditor satisfy himself that the payment is, in fact, in settlement of the balance in question. When a balance remains unpaid at the time of the audit, it will be necessary to seek further for proof of authenticity. Delivery documents, contracts, correspondence, orders from the customer, and other independent evidence should be examined.

The fourth objective of the audit procedures which we are considering is the formation of an opinion as to fairness of valuation, and as to description and classification on the balance sheet. The auditor can accumulate much information helpful in forming an opinion as to these matters while carrying out procedures leading to other objectives. For example, subsequent payment of an ac-

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Audit Verification of Inventory Values

By J. Andrew Crafts, C.P.A.

The verification of the values at which inventories are carried in the balance sheet represents one of the most important phases of auditing procedure. First, the amounts involved are normally substantial and material in relation to the other assets and, second, the problem involves, particularly in a manufacturing business, an understanding of generally accepted accounting principles (including cost accounting principles), together with an understanding of trade practices in the industry concerned and a familiarity with the regulations of certain Government agencies, particularly those applicable to the determination of taxable income and the determination of allowable costs under Government contracts.

Before proceeding to the verification of the values it is necessary to consider the general principles applicable to the pricing of inventories. The Committee on Accounting Procedure of the American Institute of Accountants has issued Accounting Research Bulletin No. 29, which covers the fundamentals of this subject very completely, and with which every public accounting practitioner should be completely familiar. The text of this bulletin is used as a basis for the following discussion of principles.

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The major objective of accounting for inventories is the proper determination of realized income through the process of matching appropriate costs against revenues. The inventory at any given date is in effect a residual amount remaining after this matching process, which residual amount is to be carried to future periods.

The primary basis of accounting for inventories is cost, representing the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. Although the principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work-in-process and finished goods, is difficult because of the variety of problems encountered in the allocation of costs and charges. For example, under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges rather than as a portion of the inventory cost. Also, except for the portion of general and administrative expenses that may be clearly related to production, it is generally accepted accounting practice to treat such items as period charges and to exclude them from inventory costs. Selling expenses constitute no part of inventory costs. The exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the

adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

Costs for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as "first-in, first-out", "average", and "last-in, first-out"). The major objective should be to choose that method which, under the circumstances, most clearly reflects periodic income. Usually the identity of goods is lost between the time of acquisition and the time of sale, with the result that it is impractical to attempt any precise identification of the actual goods used or sold. Where sales prices are promptly influenced by changes in reproductive costs, an assumption of the "last-in, first-out" method may be appropriate, otherwise, the "first-in, first-out" or "average" methods may be properly utilized. In other situations, a reversed mark-up procedure of inventory pricing, such as the retail inventory method, may be both practical and appropriate. Standard costs, if adjusted at reasonable intervals to reflect current conditions, are acceptable. It is obvious that financial statements will be more useful, if uniform methods of inventory pricing are adopted by all companies within a given industry. Trade associations in many of the leading industries have accomplished a great deal in standardizing accounting methods along these lines.

A departure from the cost basis of pricing the inventory is required when the usefulness of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, change in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as "market." A loss should be recognized whenever the utility of goods is impaired. The measurement of such losses is accomplished by applying the rule of pricing inventory at "cost or market, whichever is lower." In this connection, the term "market" means current replacement cost (by purchase or by reproduction, as the case may be) except that:

(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal) and

(2) Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. In other words, where the evidence indicates that cost will be recovered with an approximately normal profit upon sale in the ordinary course of business, no loss should be recognized even though replacement or reproduction costs are lower. This might be true, for example, in the case of production under firm sales contracts at fixed prices, or when a reasonable volume of future orders is assured at stable selling prices.

The rule of "cost or market, whichever is lower" may properly be applied either directly to each item or to the total of the inventory (or in some cases to the total of the components of each major category). The method should be that which most clearly reflects periodic income. While the most common practice is to apply this rule separately to each item of the inventory, if there is only one end-product category, the cost utility of the total inventory may have the greatest significance for accounting purposes. When no loss of income is expected to take place as a result of a reduction in cost prices of certain goods, because other goods forming components of the same category of finished products have a market equally in excess of cost, such components need not be adjusted to "market" to the extent that they are in balanced

quantities. The procedure adopted should, of course, be applied consistently from year to year.

When substantial and unusual losses result from the application of the rule "cost or market, whichever is lower", it will frequently be desirable to disclose the amount of the loss in the income statement as a charge separate from "cost of goods sold."

The basis of stating inventories must be consistently applied and should be disclosed in the financial statements. Whenever a significant change is made therein, there should be a disclosure of the nature of the change and, if material, the effect on income.

Accrued net losses on firm purchase commitments of goods for inventory, measured in the same way as are inventory losses, should be recognized in the accounts. The amounts thereof should, if material, be separately disclosed in the income statement. The utility of such commitments is not impaired, and hence there is no loss, when the amounts to be realized from the disposal of the future inventory items are adequately protected by firm sales contracts or when there are other circumstances which reasonably assure continuing sales without price decline.

The above principles have been laid down as applicable to business in general, including both the trading and the manufacturing concerns. In the manufacturing concern, however, there are special factors which must be considered in the determination of the cost to be applied to work-in-process and finished goods in the balance sheet, as distinct from the cost determined for purposes of the income statement under the accounting routines in effect. If the factory overhead costs have been under-absorbed by charges to work-in-process during the period to a material extent, it is apparent that the cost of the finished product in the inventory, so determined, is less than a proper and actual cost and vice versa. If, under standard cost procedures, the variances are of material amounts, the standard costs applied to work-in-process and finished goods in the balance sheet will be incorrect. Unless such variations can be assigned as idle facility expense or to some other category which should be treated as a current period charge, under the principles set forth above, it may be necessary that the unit costs of the inventories of work-in-process and finished goods be recomputed for balance sheet purposes.

In connection with the "last-in, first-out" method it should be noted that, if the inventory values so determined are above market, adjustment or disclosure is required. It would likewise appear desirable and informative to disclose any substantial or material understatement of inventory values with relation to replacement cost.

Regulation S-X of the Securities and Exchange Commission, which sets forth the accounting requirements applicable to the majority of the registration statements and annual report forms under the Securities Act of 1933 and the Securities Exchange Act of 1934, contains the following instructions as to inventories:

> "(a) State separately in the balance sheet or in a note therein referred to, major classes of inventory such as (1) Finished Goods; (2) Work in Process; (3) Raw Materials; and (4) Supplies. Any other classification that is reasonably informative may be used.
>
> "(b) The basis of determining the amounts shown in the balance sheet shall be stated. If a basis such as 'cost', 'market' or 'cost or market, whichever is lower' is given, there shall also be given to the extent practicable a general indication of the method of determining the 'cost' or 'market': e.g., 'average cost' or 'first-in first-out'."

As to the cost of goods sold this same regulation contains the following:

> "(a) State here the amount of cost of goods sold as regularly computed under the system of accounting followed. If opening and closing inventories are used in the computation, state amounts of such inventories here or in a note referred to and state the basis of determining such amounts."

The rules as to accountants' certifi-

cates in this regulation require that the accountant state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances and whether there was omitted any procedure deemed necessary by the accountant under the circumstances of the particular case.

Federal Income Tax Regulations 111 contain some very informative rules as to the handling and valuation of inventories. The accountant must recognize that these regulations have been prepared very carefully by expert draftsmen for general application, on the basis of the experience of the Treasury Department and the Court decisions over a long period of years. They are well worthy of careful study by any student of accounting. Without attempting to set forth the contents of these regulations your attention is called to certain of the basic provisions included therein as follows:

The valuation of inventories must conform to two tests:

"(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income."

* * *

"In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation. . . ."

"Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition. . . ."

Such regulations also provide that "The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz.:

"(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

"(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

"(3) Omitting portions of the stock on hand.

"(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

"(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer."

In planning the audit verification of the inventory values, it is important that the procedure be adequate for the purpose and also that it should not consume an amount of time which is unreasonable with relation to the objectives of the engagement. In planning such audit procedures it is pertinent to consider the basic principles set forth in the booklet published by the American Institute of Accountants under the designation "Examination of Financial Statements by Independent Public Accountants." These principles prescribe that the accountant shall check the accuracy of the computations, footings and recapitulations of the inventory sufficiently to be satisfied as to the substantial accuracy of the clerical work performed; and also that the goods are valued in accordnace with the usual commercial practice—that is, at "cost or market, whichever is lower", or some other reasonable basis which is accepted as sound accounting practice in the particular trade or business. As to quality and condition of stock the accountant must rely principally for information upon the responsible officers and employees of the company. It is generally agreed that while the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer or expert in materials, he should undertake such procedures as are necessary to satisfy himself as to the credibility of the representations of the management as to the condition of materials. In verifying inventory cost prices the accountant should ascertain that trade discounts are deducted; that cash discounts are or are not deducted on a consistent basis depending upon the

practice of the trade and of the particular company concerned. Market prices may be determined by obtaining current quotations, consulting trade journals and by comparison with recent purchases. Replacement costs should be considered and also selling prices less shipping and selling expenses. In the case of raw materials and merchandise purchased, the accountant should make a test comparison of cost prices used with purchase invoices or other sources of information. He should also effect a general examination and test of the cost system in force as the best means of checking the cost of the work-in-process and finished goods; see that no selling expenses, interest charges or administrative expenses are included in the factory overhead cost (except so far as administrative expenses apply to production); see that any interdepartmental or intercompany profits are eliminated from the inventories; and that the factory overhead cost is equitably distributed over the various departments, shops and commodities. He should ascertain whether overhead allocation is based on actual production or normal capacity (with preference to the latter). If duties, freight, insurance and other direct charges have been added, the amounts should be tested to ascertain that they are proper. He should give consideration to the possibility that obsolete, excessive, damaged or unsalable stock may be included in the inventories at greater than realizable values; make test of detailed stock records to determine if the quantities are reasonable in relation to average consumption and purchase; and discuss with responsible officials.

He should make inquiry to ascertain if the company has discontinued the manufacture of any of its products during the year; if so, the inventory of such products or parts thereof should be carefully scrutinized and provision made for anticipated losses.

In the case of part shipments or uncompleted contracts, it is preferable not to take up profits except in cases where the information available clearly indicates that a partial profit has been realized. He should ascertain from the contracts the selling prices for contract work in progress and, if it is apparent that there will be a loss on the completed contract, provision should be made for the estimated loss.

He should check the inventory total by the "gross profit test", comparing the percentage of gross profit with that of previous years. In a business in which the average gross profit has been fairly constant, this test is satisfactory; if the rate of gross profit is not maintained and the discrepancy cannot be explained by a rise or a fall in the cost of production or in the selling prices, the difference may be due to errors in the inventory.

He should ascertain that the inventories at the beginning and at the end of the period are stated on the same basis, determined generally in the same manner, or if not, the approximate effect on the operating results.

Advance payments on account of purchase contracts for future delivery should preferably be shown in the balance sheet under a separate heading. If stocks have been hypothecated, that fact and the book value of the stocks hypothecated should be stated on the balance sheet.

Whenever a cost system is not adequately controlled by the financial accounting, special attention is required in determining the values of the inventories of work-in-process and of finished goods. In such cases it will be necessary to review and evaluate the cost routines in effect, if any, and to ascertain that the basis of pricing the inventory is substantially accurate and consistent.

In some manufacturing companies the accountant will find that no cost system is in effect. In such cases the quantities must obviously be determined by a physical inventory expressed in terms of the respective stages of completion and material content of the work-in-process. The prices used

must be determined as to each stage of completion and each stage of material content on the basis of direct material, direct labor and factory overhead applied. Such prices should be determined by the management on the basis of adequate procedures, which should be carefully reviewed and tested by the accountant to satisfy him as to their substantial accuracy.

In general, the accountant should ascertain that all generally accepted accounting principles applicable to the circumstances are being carried out on a consistent basis. He should place due reliance on any system of internal control regularly maintained by the client's organization, but by appropriate measures should satisfy himself that such internal control routines are in fact being followed.

From a practical standpoint it is always helpful for the accountant to understand the varying points of view of management. In some manufacturing companies he will find that the accounting is dominated by the old-school type of production executive, who avoids the refinements of adequate cost accounting and who provides a somewhat inadequate basis for substantiating the prices used in the inventory. In other cases he will find that in a year of high taxes the closing inventory is valued on an extremely conservatively low basis which, while proper in itself, is not consistent with that of the opening inventory. He may find that in anticipation of public financing or extensions of credit from banks the inventory is stated on an optimistic or high basis. He may find that inadequate accounting procedures or carelessness have resulted in inaccurate determination of values, either plus or minus. In such cases the accountant should see that the values as to which he certifies are accurate and proper and should remember that he has a real and substantial responsibility in that connection. He is staking his professional reputation when he gives an opinion as to the balance sheet of his client and he cannot afford to have his professional reputation damaged by any possible disclosures of negligence or lack of professional ability.

It may be interesting to review certain of the practical problems with regard to inventory valuations which have been met by the writer in the course of his practice.

In auditing the accounts of a group of affiliated manufacturing companies for purposes of certifying a consolidated balance sheet, it was found that substantial sales had been effected by certain companies of the affiliated group to other companies within the group, and that by reason of certain practical difficulties in the determination of the amount of unrealized profits on such intercompany sales, included in the opening and closing inventories, such profits had not been eliminated, nor had it been the practice in the past to disclose in the balance sheet the existence or the amount of such unrealized profits. In this instance the amount of unrealized profits was determined by a special study of the facts and a correction made by eliminating such intercompany profits from the inventory as stated in the consolidated balance sheet.

In reviewing the prior years' tax returns of a manufacturing corporation it was found that at the close of a given year the corporation had had an abnormally large inventory of its basic raw material; that the prices of such basic raw material were continuing to decline; and that a substantial adjustment for anticipated decline in value had been deducted from the closing inventory as stated in the balance sheet and profit and loss statement. The effect of this adjustment had been to transfer taxable income from a year in which the tax rates were relatively low to another year in which the rates were high. Obviously the deduction for anticipated price decline was improper and the correction resulted in a substantial tax refund to the corporation.

In an audit of the accounts of a manufacturing corporation it was found

that there was a very substantial inventory of work-in-process representing materials being manufactured under a Government contract. The cost routines were entirely adequate and the costs were verified in a satisfactory manner. The management was requested to furnish an estimate of the cost to complete the contract in question, and it was found that the costs already incurred plus the estimated costs to complete were considerably in excess of the contract price which would be realized upon completion and delivery. Obviously it was necessary to reduce the value of this inventory to the net realizable value and further to disclose in a footnote to the balance sheet the probable additional loss which would be incurred in the completion of such contract.

In auditing the accounts of a manufacturing company it was found that the rate used for the application of factory overhead to manufacturing cost was considerably lower than the actual overhead, with the result that there was a substantial unabsorbed overhead balance at the end of the year, which was charged off to expense. The inventories of work-in-process and finished goods were stated in the balance sheet at the unit costs determined by the cost system. Such inventories were obviously understated by that portion of the unabsorbed factory overhead, which had not been included in the unit costs. Inasmuch as the amounts involved were substantial and material the unit costs were recomputed and the balance sheet values increased.

The same situation results from the use of standard costs where the amount of the variances is sufficiently large to indicate a substantial and material error in the standard costs used for purposes of pricing the work in process and finished goods. Where the amount of such variances is large enough to be material, and investigation reveals that the cause of such variances does not fall in a category which would warrant charging the amount thereof to the period concerned, the inventory values should be refigured on a proper basis.

In some cases it will be found that the volume of production in a factory has been so abnormally low as to inflate the actual costs of production far beyond the normal cost by reason of the high unit cost of fixed overhead charged to the product. In such cases the normal unit cost of fixed overhead should be determined and applied to the production for the period, including the residual inventories. The unabsorbed fixed overhead, under these circumstances, is a proper charge to expense of the period, as the cost of idle facilities.

Certain industries dealing in so-called by-products and joint-products present special problems. In general, where the by-products are minor in amount as compared to the main products, the net yield from the sale of by-products is often treated as a reduction of the cost of the main products, while the inventories of by-products are priced at estimated sale price less cost of distribution. Where the by-products are relatively substantial in amount, or where there are joint-products, it may be necessary or desirable to arrive at some fair and reasonable basis of allocating the purchase and processing costs against the respective products. Frequently this basis must be arbitrary in certain respects. Usually the customs of the trade or industry concerned have established a standardized and reasonable basis for the treatment of such items.

In the imported china business the determination of "landed cost" as to inventories presents many interesting problems by reason of the necessity for apportioning the cost of foreign exchange, import duties, ocean freight, insurance, warehouse costs, transportation and other charges to the many types, sizes and patterns of the respective pieces of china concerned. This business likewise presents certain problems with regard to the valuation of

broken sets of china, discontinued patterns and the like.

The industrial diamond business has certain peculiar problems as to inventory valuations. Such diamonds are usually bought by dealers in lots containing a considerable variety of sizes and grades. These lots are usually resorted into the various grades and sizes in which they are normally sold to the trade. The per carat value of these various sublots will vary substantially, with the result that it becomes necessary to apportion the aggregate cost of the entire lot purchased over the various sublots into which the diamonds may be sorted, and further, to merge such apportioned costs into the various standard categories of the inventory. Furthermore, as diamonds are sold from these respective categories it becomes necessary to determine the applicable cost of the diamonds sold and to revise the average cost of the residue.

The determination of costs under the retail inventory method involves many problems peculiar to itself. Inventories in foreign countries involve the translation of costs in foreign currencies to U. S. dollar costs and the treatment of fluctuations in exchange rates between the dates of manufacture or purchase and the balance sheet date.

The above discussion purports merely to set forth the general principles applicable to the determination and verification of inventory values, together with a reference to the basic sources of authority for such principles. The application of these principles to any given situation requires a careful study of the particular facts concerned and the customs of the trade or business concerned as a basis for the interpretation and application of these principles.

Audit of Accounts Receivable

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count is conclusive evidence of its value. Special steps relating to this objective will include discussion of accounts with the credit manager or treasurer or whatever person has authoritative knowledge of the accounts; examination of returns and allowance records subsequent to the balance sheet date; and reference to independent evidence of the customer's ability to pay, such as credit reports and financial statements of the customer.

The Cost and Value Controversy

By Maurice E. Peloubet, C.P.A.

In one of his musical comedy hits, the inimitable Victor Moore was asked rather roughly by one of the characters, "Are you a man or a mouse?" Victor Moore gave him one of his characteristic pitiful and bewildered looks and asked, "Isn't there anything in between." That, to me, is a fair summing up of the position of a large part of the accounting profession, both in public work and private employ. They are faced by the question, "Is corporate stewardship and responsibility an obligation to maintain intact the corporate capital in property: tangible or intangible assets, or is corporate stewardship and responsibility solely directed towards maintaining the monetary capital of the enterprise?" In these days of mild inflation at home, severe inflation abroad, managed currency everywhere, and currency with a metallic base a thing of the past, it is hardly possible to come right out plainly and clearly and say that corporate responsibility and stewardship is discharged by merely maintaining the capital in dollars, at whatever their value might be. There are enterprises where the mere maintenance of the dollar capital is a proper and adequate discharge of corporate stewardship and responsibility. Such enterprises are mere dealers in dollars without any regard to their value. Life insurance companies, banks, mortgage companies, loan associations, are examples of this type of enterprise. The premiums received by an insurance company over twenty years on a policy may be three or four times the value of the policy in purchasing power at the date of death of the insured. Premiums of $250 per year on a $10,000 policy over thirty years would amount to $7,500—the purchasing power of that money, as it was paid in, would be closer to $15,000 in present dollars. All this is a serious matter to the insured and to the beneficiary, but it is of little concern to the life insurance company. The life insurance company did nothing but contract to deliver dollars to be paid to a specified beneficiary on the happening of a specified event. If the insurance company receives an adequate dollar income in depreciated dollars and if it gets back its nominal monetary investment in depreciated dollars, it can pay off its obligation in depreciated dollars and no one is the worse off except the unfortunate policyholder. The insurance company, how-

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This paper was presented by Mr. Peloubet on February 25, 1950, at a meeting of The Technical Valuation Society, Inc.

ever, has kept its contract and has satisfied the requirements of its corporate stewardship and responsibility.

The same is true with a bank. A bank may lend money when the value of money is high, it may collect when it is low. The bank does not need to worry about this because its obligations are in dollars. It does not even assume the dollar value is different. It just doesn't care; there is no reason it should. It is doing its job and it is carrying out its contract obligations. The inequalities from a purchasing power point of view may be as great on one side as on the other. The stockholders of the bank, however, may suffer. They may have made an investment in high value dollars some years ago and may now be receiving income in current depreciated dollars.

In manufacturing, trading and service enterprises, the situation is entirely different and even those members of the accounting profession who do not desire, or who even shrink from, change are sure to agree that there is a question and that there is a problem. They have, however, two "in between" answers. One is, "While the value of the dollar has gone down it hasn't gone far enough to be really serious." The other is, "The value of the dollar always goes down after a war, always comes up again, it always has, it always will, therefore, we should not be unduly disturbed by a temporary condition."

I can think of nothing which would make me happier than to agree with those of my colleagues who adopt this reasoning. I disagree with them definitely but unwillingly. Assuming an orderly evolution of our society in accordance with the forms of law and without violence except as we have it now, sporadically and in small amounts, and without widespread political revolution, I cannot see how there is any possibility within the lifetime of anyone in this room for prices to go down to where they were fifteen or twenty years ago. I am willing to admit that past economic events seem to indicate that prices generally go down after wartime inflation but I think before we assume this will happen we must face a few vital facts.

If conditions were the same as in the past, I could agree with reasoning based on past results. But we know that conditions are quite different. Reliance that the economic future will parallel the economic past is based on the assumption that we will operate on a currency with a metallic or other fixed base, that we will operate under conditions of comparatively unrestricted trade movements and that there will be comparatively unrestricted movement of foreign exchange and individuals between countries. None of these conditions exist nor are they likely to exist again for many years, if ever. No government, once it realizes what an enormous increase of its power is brought about by the use of a managed currency, will ever give it up. Someone may tell us that we had an irredeemable currency after the Civil War until 1873. That is true, but we did not have a managed currency and the government had no intention of maintaining an irredeemable currency indefinitely. Furthermore, the pressure of the gold pound sterling, which was the standard in effect throughout the rest of the world, was too strong on this country to be resisted.

Now, however, we have managed currencies in practically all countries. This means, in plain words, that the government can increase or decrease the amount of money in a country at will. The government seldom wishes to decrease the amount of money in a country. It seldom wishes to increase interest rates. It seldom wishes to decrease its own expenditures and it seldom wishes to decrease the total of its collections. A very enlightened government may realize that under some circumstances it can get more tax by lower rates but its purpose is to get a larger amount of tax to take care of the ever-increasing requirements for government spending.

In addition to, and partly as a corollary to, increased government spending, government debts, and tax requirements, we have a tendency, probably never experienced on any great scale in an industrial country before the present era, for wages to increase faster than productivity. This necessarily results in inflation of the dollar over a period although its effects are irregular and delayed. We cannot continue to take out more in wages than is put in in productivity without decreasing the value of the monetary unit in which the wages are paid. Furthermore, there are many things which will make substantial reduction in wages, during even a serious recession in business, improbable if not impossible. We operate under a very high minimum wage law. Other devices, such as the Walsh-Healy Act, tend to maintain high wages. We have the direct action of the government in paying high wages to hold employees and to get them from industry. In times of recession or decrease in production, we will undoubtedly have public works projects taking up the slack of employment at prevailing rates. All this makes for rigidity or a rising tendency in wage rates and there is, in my opinion, no immediate prospect of change. When I say immediate I mean ten, twenty, or thirty years. In view of all this, I am unable to agree with those of my colleagues who say that it isn't serious and even if it were serious everything will go back to the way it was before the war or lower. That just can't happen, in my opinion, because we don't have the same conditions. Our old type of government is called by some, I believe, the "Umpire" state. The kind of government we have now is called by a number of names. The names you call the government depend to a certain extent upon your politics or the sort of breakfast you've had, but, in general, if you like the present kind of government you call it the Welfare State or some other name that indicates that it is a government responsive to the needs of the people, but if you do not like such a government you call it a Planned Economy, a Hand-out State, an Economic Dictatorship, Disguised Socialism, or some other more or less derogatory name indicating that it is a government which has taken great and presumably improper power for itself. Whatever your feelings towards the government, whatever names you call it, there is no disagreement about what it does and how it does it.

Some government operations are quite difficult to understand and are obscurely expressed. It may be that it is impossible to express some government operations clearly. In any event the workings of many government programs and projects are not thoroughly understood, and, therefore, the final effects are not. Whether the proponents of all of these methods understand the final effects is doubtful also, but we can be sure of the final result. The result will be more and more power for the government and less and less value for the dollar. As individuals we may well deplore this condition, we may fight it politically, but as those who are responsible for the proper exercise of corporate stewardship, we can do little more than Margaret Fuller did with the Universe, that is, accept it.

If we accept these conclusions, we must also agree that corporate stewardship and responsibility is for property, things, tangible and intangible rights of value and is not a responsibility for the mere maintenance of money capital. We are then faced with the question, "Does Accounting on a cost basis only, when cost is expressed in terms of dollars varying widely in value in different years, give management the records needed for the proper operation of a corporate enterprise and for a proper discharge of the corporate stewardship." I do not see how there can be any other answer than "No" to that question.

I am reminded of a successful businessman in a small town in the West. There was some question of excess

profits tax. It appeared that the best basis for this company was invested capital. The sons quizzed the old man about the original capital and he said, "If you really want to know what the original capital of this company is, I think I can show you. If you go up into the loft, in a corner, you will find hung on one of the beams an old pack that I had on my back when I first came to this town. I decided that it was a good town, I opened a store and that was the original capital. It was the only capital that ever went into this business from the outside." All the rest of the capital was represented by the buildings, the stock-in-trade, the contract commitments the firm had. It was not necessarily represented by any particular amount of money, it was not represented by any securities and the fact that the company's worth was represented by dollars did not mean that they had dollars as property. The capital the old man started with was things. The capital that he and his sons had built up was things, buildings, delivery wagons, stock-in-trade; and the capital that his sons had to preserve and maintain from thenceforth was those same things. The amounts in which it was expressed were comparatively unimportant.

If this capital is not maintained we will find ourselves in a position like, for example, the textile and coal industries in England. Whether capital is destroyed or eroded by excessive taxes or by excessive payments to proprietors, which is the same as making an insufficient provision for replacement, renewal and improvement of machinery and equipment, or whether it is taken away in the form of excessive wages, the result is the same. In those industries where the machinery gets older and older, where replacement and improvement is more and more inadequate, where any machines which will turn out a product which can be sold at all are supposed to be modern and efficient machines, the inevitable result of the failure to improve, advance or maintain is higher costs, lower and lower productivity, smaller and smaller profits. It means a gradual drying up of industry. The industrial climate will suffer a change, somewhat like that of North Africa, where under the Carthaginians, it was a prosperous country, but where winds from the Sahara pushed the sands up further and further, gradually reducing the fertile area, producing a desert at places almost to the edge of the sea.

Now, if we agree that what has been said is a reasonably correct statement of the conditions, what are we going to do about it? First, we must find out what the value of plant, buildings, machinery and equipment is in present-day dollars. We must make a proper annual charge to income for this. We must see to it that proper additional annual charges to income result in retaining in the business amounts to be used sooner or later for the replacement, extension and improvement of the buildings, plant, machinery and equipment.

We may not be able to obtain the exact facts and figures for this but we can come close enough for all practical purposes, certainly close enough to provide a reasonable safeguard for ourselves. Before the Securities and Exchange Commission took a positive and opposed position on replacement depreciation, several companies had made good estimates of depreciation on replacement values and several companies are still publishing these estimates as supplementary information. Almost everyone has replacement values for insurance. The difficulties of obtaining replacement values and depreciation figures have been exaggerated. At present all we can put aside is subject to income taxes. We are taxed on everything which is put aside for replacement. However, if enough is said, if enough companies adopt a reasonable method for their accounts, if we can once get the accounting profession to agree that provision for replacement is proper and necessary it will be difficult for the Bureau of Internal Revenue and the Treasury Department to hold out long against legislation

which will permit the deduction of replacement depreciation from taxable income.

We cannot maintain our present position in productivity and in technical advancement unless we recognize the necessity of providing for the improvement of our mechanical plant and equipment. Our position can be jeopardized and hampered by oppressive and ill-advised taxation such as we have at present. It can be damaged by the excessive demands of labor and possibly by the excessive demands of stockholders who see apparent profits which do not really exist. So long as management realizes this difficulty, so long as management knows that it must replace and improve, and so long as management realizes that money which should be spent for replacement is now being taken away in the form of taxes, is being paid to labor in the form of excessive wages, is being demanded by stockholders in the form of dividends, it is the duty of management to state clearly what should have been spent and what has been reserved for replacement. Management should spend for replacement of machinery, plant and equipment what is left of it, after taxes and other demands, as wisely as possible. It should also make it perfectly clear to the public and the government that what remains, after taxes and the various other demands made upon corporate income, is generally insufficient for full and adequate replacement and maintenance, and management should generally indicate the extent to which it believes the provision for replacement in depreciated dollars is insufficient to replace or maintain capital originally acquired for higher-valued dollars. The responsibility is basically that of management and of management's advisers. The interest of management in maintaining the industrial fabric of the country is great but it is no greater than the interest of labor. However, neither government nor labor seem to be aware of what is happening. All sections of management do not see what is coming, but some do. The first step towards preventing the evaporation of our industrial capital is for those members of the management group who realize this situation to convert their colleagues and their advisors; the second step, is probably to convert those government officials and legislators concerned with this problem and if that is done, it is possible labor and investors can finally be persuaded that it is better to have a cow and milk her and set aside enough from the milk money to replace the cow than it is to have one enormous, glorious steak barbecue and then do without milk forever.

* * *

Bibliography

The literature on the subject of cost or value as a basis for accounting is becoming fairly voluminous. However, a careful reading of a comparatively small number of books and articles will give a sound foundation for thinking on this question.

Probably the best technical statement of the problem of replacement in all its phases is the book —

Dynamic Equipment Policy by George Terborgh, published by the McGraw-Hill Book Company.

Pamphlets by the Machinery and Allied Products Institute, by the same author, which describe important aspects of the problem are:

Inflation and Postwar Profits,

Capital Goods Industries and Tax Reform, and

Depreciation Policy and the Postwar Price Level.

The Study Group on Business Income, organized by the American Institute of Accountants in 1948, has published two pamphlets which sum up present advanced thinking on this subject. These are:

An Inquiry Into the Nature of Business Income Under Present Price Levels, by Arthur H. Dean and

Business Income and Price Levels—An Accounting Study, by George O. May.

The Problem of Depreciation—1920 Versus Today

By Gerald S. Kohl, C.P.A.

In accounting, as in other human affairs, it may be said that history repeats itself. A careful study of the literature of accountancy shows clearly that inflation is today affecting depreciation, renewal cost of fixed assets, and inventory pricing, in precisely the way that it did in the years following 1919. A re-examination of the articles written by accountants in their professional journals during the period 1918 to 1920 shows equally clearly that the problems which engrossed their attention then were the same as those confronting them today.

The United States was in the midst of a drastic period of inflation in 1920. As a consequence, accountants were then discussing problems similar to those of today and arriving at about the same conclusions as now. Since we are not, therefore, traveling a new path, but instead are retracing a cycle, it might be useful to review the thinking of some representative accountants of that era and compare it with those of today.

The inflationary periods of the 1920's and the 1940's follow closely upon two world wars. This suggests that war may generate economic maladjustments so severe as to start the forces of inflation into action. We know from experience that during the early stages of inflation there is a period of false prosperity. This occurs because at first prices rise faster than costs. It is only when costs begin to overtake prices that economic stability is endangered. This danger point does not arrive unannounced. In fact, accountants in 1920 were duly warned regarding the baneful effects of inflation and advised to take remedial steps in accounting practice.

Theories regarding the cause of inflation were first developed deductively by John Locke and others in the latter part of the seventeenth and the early part of the eighteenth centuries. In expounding their initial theories on price fluctuations, these men were limited to deductive thinking because adequate business statistics were not then available. Later economists were able to use inductive reasoning because by then enough data had been collected to permit the development of reliable price and cost-of-living indexes. As early as 1918, accountants saw the possibility of applying such indexes to financial statements in a manner designed to compensate for discrepancies or lack of comparability caused by the changing value of money. Thirty years later, the principle was actually incorporated into the labor contract of one big corporation. That contract provided for wage adjustments on the basis of a cost-of-living index.

In reviewing accounting principles and practices in vogue three decades ago, one should bear in mind that accountants of that date did not have the benefit of a codifying agency such as the present Committee on Accounting Procedure of the American Institute of Accountants, nor were facilities for general discussion as available as they are today. Despite this lack, the problems of depreciation and renewal cost were posed succinctly by John Bauer in the December, 1919, issue of the *Jour-*

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nal of Accountancy, when he warned that,

> "Industrial management faces a grave danger during a period of rising prices in that revenues or gross earnings show the full effect immediately, while many of the additional costs are more hidden and are not fully disclosed in the accounts as they are incurred but finally cannot be avoided. This results for a time in an overstatement of profits and unjustified payment of dividends or withdrawal of earnings, but in the end means waste of capital and loss of income. . . .
>
> "I wish to discuss one particular cost which is being generally overlooked, but which, in the end, will have to be faced by all business and society at large—the allowance for depreciation on renewal of industrial plant. . . .
>
> ". . . If the present level (of prices) continues, or is maintained to such extent that renewals will cost more than property retired, the recognized allowance for renewals is inadequate and should be raised in proportion to the higher prices.
>
> ". . . The purpose of management certainly must be to maintain the physical plant, and to keep up production without drawing upon capital funds. If this be true, then when the price level has risen, the charge to operation for renewals should not be the original cost of property retired, but the cost of new property which in function and capacity, is reqnired to replace the old. . . ."

This quotation not only illustrates how the problem of 1920 parallels that of today, but it also reveals how well it was then understood. There were, of course, other accountants at that time who did not agree with Bauer in his conclusion that operations should bear the added expense of renewals. Ernest S. Rastall, two months later, in February, 1919, writing in the same magazine, declared that,

> ". . . To set up replacement reserve or even an enlargement reserve by a debit to surplus and a credit to reserve would be permissible, but it would not be correct procedure to charge it to surplus via the operating route."

W. A. Paton, in the July, 1920, *Journal* had the following to say respecting the above two articles:

> "An elaborate argument can be made on either side of this proposition. It has been the purpose of this paper merely to point out the limitations inherent in accounting as a means of showing comparative economic well-being. . . .
>
> "Now, while it is perhaps not unreasonable to argue that the accountant should prepare supplementary statements at the end of each period designed to show—by making proper allowance for the change in the value of money—the true comparative economic status of the enterprise, it should be emphasized that it is, above all, important that the financial statements present as accurate as possible a picture of current status and current results in terms of the actual dollar at the date of the statements and this is a matter not of general price movements—which may be said to express fluctuations in the significance of money—but of specific price changes."

L. Middleditch, in the February, 1918, issue of the *Journal of Accountancy,* inquired:

> "Would it not be scientific, sound accounting practice, in those instances in which it makes an essential difference, to make the books of account reflect the changes in the value of the monetary units?"

Even "Lifo" was considered in the yearly period. True, it was not given that name, but the thought was there. J. Paul Suter said in April, 1920, in the *Journal:*

> ". . . A persistently rising cost of manufacture may make it advisable to use the current production first. During the Great War, one of the largest corporations in America instructed its cost accountants to use either the previous balance or the current production first, whichever was the higher in price. This practice delayed the closing of the corporation's books, but it resulted in a conservatively priced inventory. . . ."

The foregoing quotations are but a few of many which might be cited to show that accountants of thirty years ago realized that the principles and practices of accounting were being put to a hard test.

No action, however, became necessary in 1920, because by the end of that year, a drastic period of deflation began. There is considerable evidence suggesting that today's upward surge of prices may level off and again obviate any change in existing accounting principles.

What to Think About When Terminating the Marital Relationship. What Is New in Alimony Cases?

By Miriam I. R. Eolis, C.P.A.

In the ordinary course of living, one would expect that the last thing to think about when terminating the marital relationship would be the deductibility of alimony on a tax return. But in the extraordinary habitation of the tax man's world where deductions glow, and personalities fade, the tenor of this paper will be at least appropriate if not quite humane.

When a man pays alimony to a spouse who is no longer warming his heart or his bed, he now receives the negative consolation that he is saving more in taxes without her than with her, and the affirmative pleasure that she, as a taxpayer, is getting less than she bargained for. Until 1942, disgruntled and deserted ex-husbands were often maintaining one, two or more women in complete respectability, without any of the benefits pertaining thereto. Under *Gould* v. *Gould*,[1] the courts were of the opinion that cloistered womanhood should not be exposed to the rigors of taxability, and it was there held that alimony paid was neither deductible by the husband nor taxable to the wife. The legislators, who lacked the gallantry of the courts, included in the Revenue Act of 1942 three Sections[2] which revolutionized the whole economic structure of marital rift adjustments. Alimony paid in compliance with these new sections was made taxable to the wife and deductible to the husband. The courts, being less radical than the legislators, have, however, been very strict in their construction of the new statute, and woe to the trusting husband who does not follow the letter of the law.

The new law has produced and continues to produce a plethora of tax cases in the field of alimony. Some of the litigation is unavoidable because of the friction out of which alimony agreements are conceived. However, certain precautions can be taken in the preparation of these agreements to minimize the tax conflicts.

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[1] Gould v. Gould, 245 U.S. 151 (1918).
[2] I.R.C. §§ 22(k), 23(u), 171(a).

Precautions in preparation of agreements

While the law does not make it necessary to incorporate alimony agreements into the decree of divorce, experience has shown that it is highly desirable.[3] The courts are apt to hold that gentlemen's agreements between the parties are not "incident to the divorce decree", and therefore alimony paid under such agreements does not constitute a tax deduction to the husband. To avoid doubt, the agreement should be incorporated into the decree.

Where there are minor children involved, the alimony provisions of an agreement should omit any reference to the amounts intended for maintenance of the children. Otherwise the husband should be warned that taxwise he may be giving away his alimony deduction. Case after case[4] has been decided against the husband, disallowing a deduction for alimony where the most remote contingent provisions are made for minor children in the agreement. Specific provision, contingent or otherwise, for minor children should be omitted from agreements.

Lump sum agreements

Where alimony in a lump sum has been agreed upon, and the parties intend that it be paid in instalments over a ten year period, exceeding care should be taken in the measure of the ten year period. The dating of the decree rather than of the agreement starts the ten year period running. Occasionally a matter of a few days' variation in these dates has made the difference between having and losing an alimony deduction. In measuring the ten year period, the agreement should run for either substantially more or substantially less than ten years.

Frequently, in divorce situations, the husband irrevocably assigns insurance policies to his ex-wife and agrees to pay the premiums thereon. The courts are not consistent within themselves or in agreement with each other whether the premiums so paid are deductible as alimony. The ready solution is to word the agreement so that the husband pays the amount of the premium to the wife, who in turn makes the premium payment directly to the insurance company. If the parties cannot so agree on the terms, the husband should be adequately warned that he may not be entitled to the deduction.

Where a husband can wipe the slate clean at the termination of his marriage by a small, or even a large, lump sum payment, rejoicing may indeed be his. But taxwise he has forgone one of his most luxurious consolatory deductions. The statute requires the magical "periodic payments" as a permanent or at least lengthy reminder to an erring husband to justify his tax saving via the alimony route. For tax saving purposes, avoid lump sum payments.

Inequities

Gross inequities exist under the alimony provisions of the tax law, occasionally for the wife, but more frequently for the husband.

Temporary alimony paid "pendente lite" under a court order in an action for divorce is not deductible to the husband.[5] The payment to qualify for the prize of deductibility must be made subsequent to the decree of divorce. The fact that it is made pursuant to court decree in and of itself is not sufficient.

Payment of alimony pursuant to a separation agreement between the parties but not given the sanction of the court's signature is not within the compass of deductibility. It is understandable that a provision like Section 23(u) of the Code might provoke occasional

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[3] Charles L. Brown, 7 T.C. 715 (1946); Luckie G. Hesse, 7 T.C. 700 (1946); G.C.M. 25250, 1947-2, C.B. 32.

[4] Elsa B. Chapin, T.C. memo. Dkt. 10971 (1947); Robert W. Budd, 7 T.C. 413 (aff'd. C.C.A.—6th) (1947).

[5] George D. Wick, 161 F.(2d) 732 (1947).

collusion between husbands and wives to divide a portion of income and reduce taxes. However, collusion under many sections of the tax law is something against which the government must guard itself. It seems unreasonable to prejudice the taxing status of parties to private separation agreements in favor of those who obtain judicial sanction, merely to reduce the incidence of collusion. Furthermore, under the present law of split income returns, the whole theory falls, since married couples no longer have the incentive to assign income to the wife. The whole subject of separation agreements as a factor in the deductibility of alimony needs review and revision.

Payments of alimony made pursuant to a court order directing support but not separation are not deductible.[6] The premise is that there is no separation agreement or decree of legal separation. The actual physical separation is insufficient to qualify the payments.

A retroactive decree cannot qualify payments made prior to the decree itself.[7] It seems highly inequitable, in a field where judicial sanction maintains the exalted status it has under the alimony tax provisions, that it should be given no cognizance in retroactive decrees.

Occasionally, the wife is penalized and subjected to undue tax hardship under the alimony provisions.[8] Where the decree of separation or divorce was entered before 1942, what was intended as maintenance for minor children may well have been labeled alimony because there was no difference in its handling taxwise. Subsequent to 1942, a wife in such a position may find herself taxed on moneys intended and expended exclusively for the children. Contrary to the intent of the parties and of the old law, she may suffer a substantial monetary loss. Although she may have recourse to the courts to reopen the old decree and obtain modification, the psychological and emotional deterrents to such action cannot be completely overlooked.

Alimony trusts

A curious and wholly inequitable situation arises in the case of alimony trusts. Ordinarily the amount of alimony deductible by the husband is taxable to the wife. However where an alimony trust is set up and the wife is guaranteed a fixed amount whether out of income or principal, the wife must report the full amount while the husband may omit only the income portion.[9]

Counsel fees paid by the husband on behalf of the wife and in accordance with a court order are not deductible to the husband. This is certainly a case of insult added to injury.[10]

Where the husband, pursuant to a divorce decree, gives the wife the use of his home, the law gives him no right to an alimony deduction of equivalent value.

Upon review of the inequities which exist, it does not necessarily follow that they all can or should be corrected. Reversing the present stand might result in even greater inequities. But the general situation should be scrutinized after seven years of litigation under the present statute, to discern what changes can and should be made.

Agreements "incident to the decree"

An analysis of the more recent cases, those decided in 1948 and 1949, indicates some of the present patterns of thinking by the courts. The courts construe in its strictest sense the meaning of the phrase "agreements incident to the decree."

In *Benjamin B. Cox,*[11] the parties entered into a written agreement for

[6] Frank J. Kalchthaler, 7 T.C. 625 (1946).
[7] Robert L. Daine, 168 F.(2d) 449 (1948).
[8] Dora H. Moiteret, 7 T.C. 640 (1946).
[9] I.T. 3856, 1947-1, C.B. 23.
[10] Jack Pappenheimer, C.C.A.-5th, 164 F. (2d) 428 (1947).
[11] 10 T.C. 955 (1949) aff'd. C.C.A.-3d.

alimony after the taxpayer obtained a Florida divorce. The court held that the agreement was not incident to the decree, since it occurred subsequent to it, and alimony paid thereunder was not deductible. Similar logic denied deduction for voluntarily increased payments which were subsequently incorporated into a retroactive modification of the decree. *Peter Van Vlaanderen.*[12]

In *Alfred Terrell,*[13] the parties entered into a private agreement providing for periodic alimony payments. The husband defaulted, and the wife obtained a decree directing payment under the agreement. The court held that payments so made were not deductible because there was no decree of separate maintenance. To the same effect was *Harold S. Smith.*[14]

In *Robert Wood Johnson*[15] the court in a rare mood went to the spirit rather than the letter of the meaning "incident to the decree." Taxpayer entered into an alimony agreement with his wife upon her oral assurance that she would obtain a divorce. The agreement did not state that it was conditional to the divorce. However, upon evidence from the attorneys who drafted the agreement that such an expression in the agreement might have constituted collusion barring divorce, the court held that upon the evidence, this was an agreement incident to the decree despite the fact that it was not made part thereof. Despite this decision it is wise to incorporate an agreement into the decree to make certain it is incident thereto.

In *Harold W. Hoyt,*[16] taxpayer and his wife entered into a private separation agreement. Thereafter an action for legal separation was begun and then discontinued. The court held that payments in accordance with the separation agreement were not deductible. However, in *Abraham L. Berman*[17] although payments made pursuant to a private separation agreement prior to a divorce decree were held not deductible, payments subsequent to the decree were allowed.

In *George T. Brady*[18] the parties entered into an alimony agreement. Subsequently, a divorce was obtained. During the divorce proceeding, a portion of the agreement was referred to, but it was not incorporated into the decree. The evidence indicated that the Massachusetts courts ordinarily refuse to incorporate alimony agreements into their decrees. Upon the facts the court held that the alimony paid was pursuant to agreement incident to the decree.

It is evident from these cases, that to insure an alimony tax deduction, separation agreements with alimony provisions should be incorporated into the decree of separation or divorce. If the agreement is made subsequent to the decree, care should be taken to have the decree modified accordingly. When the term decree is used, it should be borne in mind that a decree of separation or divorce is intended. A court decree enforcing a private agreement or a court decree compelling support are not decrees of separation or divorce, and therefore do not give the sanction necessary to justify an alimony deduction.

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[12] 10 T.C. 706 (1949) aff'd. C.C.A.-3d; see also Nathalia Danesi Murray, T.C. memo. Dkt. 14072 (1949) modified C.C.A.-2d; Miriam C. Walsh, 11 T.C. 1093 (1948); Robert L. Daine, supra, n. 7.

[13] T.C. memo. Dkt. 15682 (1948).

[14] C.C.A.-2d, 168 F.(2d) 446 (C.C.A. 2d, 1948). See also, Ben Myerson, 10 T.C. 729 (1948).

[15] Robert Wood Johnson, 10 T.C. 647 (1948).

[16] T.C. memo. Dkt. 13905 (1948).

[17] T.C. memo. Dkt. 12335 (1947).

[18] 10 T.C. 1192 (1948).

Periodic payments

In order that alimony payments may be deductible, they must be periodic in nature. Here again, the courts bend backward in the strictness of their interpretation of the meaning of the terms.

In *Frank R. Casey,*[19] payments under a divorce decree were specifically set at $5,000.00 to be paid in instalments of $100.00 a month. The court held that this was a lump sum paid in instalments and did not constitute periodic payments. An amendment of the decree requiring payment of $100.00 a month for 50 months did not remedy the situation. The payments were held not deductible. A similar result was reached where the decree called for payments of $125.00 a week for 2 years unless his wife sooner died or remarried. The court held that the payments constituted instalments of a single principal obligation, rather than periodic payments, and were not deductible. *Frank B. Orsatti.*[20]

In *Tillie Blum,*[21] the measure of the ten-year period to determine the taxability of the payments to the wife was in issue. An alimony agreement dated February 27, 1935, provided that it was to be effective upon entry of the divorce decree and that instalment payments should end March 1, 1945. The decree was entered March 2, 1935. If the period began February 27, 1935 the payments would be made over a period exceeding ten years, whereas if it began March 2, 1935, the period would be less than 10 years. The court held that since the agreement specified that it was to be effective when the decree was entered, March 2, 1935 was the beginning date. The payments were therefore not taxable to the wife.

In *Frank J. Loverin,*[22] taxpayer clearly made a lump sum payment which he sought to deduct. The court disallowed the deduction. However, the argument used by the taxpayer, while ineffective, bears reviewing. Taxpayer, under a decree of divorce was to pay his wife $60.00 a week for her support. In 1942, on contemplation of her remarriage to another person, the husband agreed to pay her $8,500.00 plus $1,500.00 for counsel fees in cancellation of his obligation to support her under the divorce decree. The husband then sought to deduct the lump sum amount on the theory that if he were to pay her $60.00 a week as required by the decree for his life or hers, their life expectancies would require that he pay her a principal sum of $88,000.00. The period of payment was in excess of 10 years, and the current year's payment was less than 10% of the principal sum. Intriguing as the argument was, the item was disallowed because it constituted a lump sum payment. In addition, it was pointed out the agreement was not incident to the divorce decree.

In *Estate of Homer Laughlin,*[23] periodic payments paid by a husband's estate in accordance with a divorce decree were held deductible to the estate and taxable to the widow.

Where the taxpayer-husband, under a decree of divorce, was obligated to pay his wife $9,500.00 at the rate of $100.00 a month unless she sooner dies or remarries, payments were held to be instalments, and not periodic payments. Amounts so paid were not deductible. *J. B. Steinel.*[24] However, in *John H. Lee,*[25] payments of a percentage of income for five years pursuant to a divorce decree were held to be periodic and, therefore deductible. The case was differentiated from the *Steinel*

[19] 12 T.C. 224 (1949).
[20] 12 T.C. 188 (1949).
[21] 10 T.C. 1131 (1948).
[22] 10 T.C. 406 (1948).
[23] Estate of Homer Laughlin, 167 F.(2d) 828 (1948).
[24] 10 T.C. 409 (1948).
[25] 10 T.C. 834 (1948).

case on the basis that there the amount was fixed in the decree..

These cases indicate that where the decree mentions a sum certain to be paid, it is generally considered a lump sum. Despite the decision in *Roland Keith Young*[26] case, it is even dangerous to set a maximum to be paid. A cautious lawyer, in preparing the agreement, will studiously avoid reference to any total amount to be paid, if he wishes to protect his client's right to an alimony deduction.

Contingent provision for minor children

Where any contingent minimum provision is made for minor children, the husband is apt to lose part of his alimony deduction. In *Warren Leslie Jr.*,[27] under a separation agreement, the husband was to pay his wife 33⅓% of his income, but not to exceed $6,000.00 a year for the support of the wife and children. Another paragraph provided for a minimum of $3,600.00 a year, and if the wife remarried, a minimum of $2,400.00 for the children. The wife did not remarry. The court held that of the $3,600.00 paid, $2,400.-00 was for the children and not deductible.

Insurance premiums

The courts are in conflict, when insurance premiums are paid by the husband for the benefit of the wife, as to the deductibility of the payments.

In *Meyer Blumenthal*,[28] under a decree of divorce the wife was to receive $5,200.00 a year. Provision was made for the husband to pay insurance premiums on policies on his life. The wife was the irrevocable beneficiary of the policies until her death or remarriage. Upon the husband's death the alimony payments were to be continued to be paid out of the insurance proceeds. The court ruled that the premium payments did not qualify as alimony.

A contrary result was reached in *Leon Mandel*,[29] where the facts were almost identical, except that upon the husband's death all the proceeds went to the wife and children: the premium payments were held to be deductible as alimony. To the same effect are *Estate of Boies C. Hart*[30] and *Anita Quinby Stewart*.[31]

Whether the *Blumenthal* case indicates a reversal of the earlier trend, or merely a difference of opinion in the Tax Court, it is difficult to say. The safest procedure is to have agreements provide for premium payments by the wife out of a proportionately larger alimony allowance.

Gift taxes

Where a husband, in contemplation of divorce or pursuant to a divorce decree, settles a lump sum of money on his wife over and above his obligation to support her, the problem of gift tax arises. The cases at the present time are none too clear as to whether such settlements constitute taxable gifts or not.

In *Commissioner* v. *Converse*,[32] under a separation agreement, the husband agreed to make monthly payments to his wife. Subsequently the wife brought an action for divorce, and sought to incorporate the terms of the separation agreement into the divorce decree. The husband objected, and the decree finally set a lump sum payment, which the husband made. The court held this was not a taxable gift because the decree created a judgment debt, and discharge of the debt was adequate consideration for the transfer.

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26 Roland Keith Young 10 T.C. 724 (1948).
27 Supra, note 25, 10 T.C. 807 (1948).
28 13 T.C. 6 (1949).
29 T.C. memo. Dkt. 16280 (1949).
30 11 T.C. 16 (1948).
31 9 T.C. 195 (1947).
32 163 F.(2d) 131 (1947).

In *Edward B. McLean,*[33] a marital settlement was made pursuant to a divorce decree. The decree provided that periodic payments should be made even if the wife should remarry. In return, the wife relinquished her rights in certain trusts. The Commissioner contended that since the husband's obligation to support ended when the wife remarried, such payments were subject to gift tax. The court, however, held that there was no taxable gift because the wife's relinquishment of her rights in the trusts, was adequate consideration therefor.

The importance of proceeding only under a court decree is seen in *Norman Taurog;*[34] the parties made an agreement providing among other things, for equal division of their community property. Shortly after, a divorce decree was entered which incorporated the agreement by reference. The Commissioner claimed that one-half of the property transferred to the wife constituted a taxable gift. The court held that since the payment was made pursuant to court decree, the husband was discharging an obligation, and there was no taxable gift.

In *Roland M. Hooker,*[35] the husband under a separation agreement and subsequent decree of divorce made payments of alimony to his wife. In addition he set up certain trusts for the maintenance of his minor son. After his son reached majority the corpus of the trusts was turned over to the son. The court held that amounts paid to the son in excess of amounts necessary for his maintenance were subject to gift tax. However, where payments flowed from the wife to the husband, a gift tax was imposed. Thus, in *Estate of Josephine S. Barnard,*[36] a wife in anticipation of a divorce agreed to pay her husband $100,000.00 for relinquishing all claims to her property. Two months later the agreement was incorporated into the divorce decree. The court held that the amount paid constituted a taxable gift on the theory that release of marital rights was not adequate consideration. A distinction was made between marital rights and an obligation to support.

It is dangerous to draw any conclusion from these cases. The safest position to take, however, is to have such transfers made in consideration of support rather than relinquishment of property rights; have them made pursuant to court decree; and then hope for the best.

Community property

A curious situation arises in community property states as to who is entitled to an alimony deduction. Thus, in *Robert A. Sharon*[37] a husband made payments of alimony under a California divorce decree to his first wife. Subsequently the husband remarried. He and his second wife filed separate returns on a community property basis and divided the alimony payments between them. The court held that where the obligation was collectible out of community funds and actually paid therefrom, the deduction may be divided, and the second wife may thus obtain an alimony deduction for payments made to the first wife.

Conclusions

The whole subject of alimony tax problems should be reviewed with an eye toward reforming and liberalizing the statute. The courts have tossed the problem about under the Revenue Act of 1942 for about seven years. Some blatant inconsistencies and inequities have developed.

If court decrees rather than private agreements are to be the safety valve to avoid collusion on the one hand and

(Continued on page 319)

33 11 T.C. 543 (1948).
34 11 T.C. 1016 (1948).
35 10 T.C. 388 (1949) aff'd. C.C.A.-5th.
36 9 T.C. 61 (1949) aff'd. C.C.A.-2d.
37 10 T.C. 1177 (1948).

Payroll Tax Savings Hints

By Samuel S. Ress

How to Avoid Additional Federal Unemployment Tax Assessments

Some recent decisions by the New York State Unemployment Insurance Appeal Board, upholding late filing penalty assessments levied by the Industrial Commissioner against taxpayers in close cases, point up hidden pitfalls in the recesses of the State and Federal Unemployment Tax Laws that prove costly to employers.

In cases* decided recently by the Appeal Board, the employer's accountant had testified that he personally had mailed the envelope containing the employer's quarterly payroll report and a check in payment of the contributions due for the first quarter of 1948, on April 30, 1948, before 5:30 P.M., in a United States Post Office mailbox located at Warren Street near Washington Street, New York City. The mail was picked up at hourly intervals starting with 1:00 P.M. until 7:00 P.M., and thereafter at 9:00, 10:00, and 11:00 P.M.

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>
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The Administrative Supervisor of the Unemployment Insurance Records in charge of the employer's contribution records in Albany offered evidence before the Board as to the manner in which tardy reports and payments of contributions are processed. Each envelope is opened separately and the contents thereof are removed and checked for accuracy. The employer's registration number, taken from the report, is written in red pencil on the face of the envelope. Both the envelope and the report are stamped to indicate the date of receipt, the examiner's number and also that "report received in envelope postmarked after due date." The envelope submitted at the hearing by the Industrial Commissioner as being the wrapper in which the employer's report was enclosed, bears the same registration number as that which appears on the report sent in by the employer, and bears a stamp mark showing the same date of receipt, the same examiner's number and that it was postmarked after the due date.

It was held that the documentary proof submitted by the Industrial Commissioner indicated that the wrapper offered in evidence was properly identified at the time of its receipt in Albany as being the one in which the employer's report and check were enclosed. Said report and wrapper were received in the New York City Post Office on May 1, and at Albany on May 3. This documentary proof contradicted the testimony of the employer's accountant that he mailed the report on April 30.

* New York State Unemployment Insurance Appeal Board, #20,245-49 and #20,243-49, decided February 24, 1950.

The Appeal Board concluded:

> "Based upon all the credible evidence in this case, we find that the employer did not make payment of contributions due for the first quarter of the calendar year in 1948 within the time prescribed by law. The determination of the Industrial Commissioner imposing an assessment for interest was therefore proper."

Had the aforesaid occurrence taken place on January 31st following the fourth quarter of the calendar year, the payment of contributions for that entire quarter would have resulted in an additional Federal Unemployment Tax amounting to 10 percent of the contributions paid for the fourth quarter of the year.

The normal Federal Unemployment Tax is 3 percent of the taxable payroll less a credit of 90 percent thereof, provided that the State Unemployment Insurance Fund has been paid an amount in cash and/or by tax credit of at least 2.7 percent of the taxable payroll on or before the January 31st due date for filing the Federal Unemployment Tax return. If the State receives payment of all or part of the State Unemployment Insurance tax after the January 31st due date, a report is made by the State to the Federal Commissioner of Internal Revenue in Washington.

The Commissioner of Internal Revenue then makes an additional tax assessment of 10% of the amount received by the State after the January 31st due date plus interest, and also penalty in appropriate cases.

In close cases, where accountants are pressed for time they can save their clients from such heavy additional tax assessments by obtaining an extension of time for filing the Federal Unemployment Tax report for the preceding calendar year. The extension may be obtained by applying to the local Collector of Internal Revenue, submitting an affidavit executed by the taxpayer setting forth valid reasons why an extension of time (not to exceed ninety days from the January 31st due date) should be granted.

Should the Collector of Internal Revenue grant a 30-day extension of time for filing the Federal Unemployment Tax return, the due date would then be March 1st, instead of January 31st. Then, all payments received by the State between January 31st and March 1st will be allowed for full credit by the Federal Unemployment Tax authorities, and the 10% additional Federal Unemployment tax will be avoided.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Tax Liability of Foreign Corporations

A foreign corporation is required to obtain a certificate of authority to do business in New York. That fact by itself does not make the corporation liable for tax. A failure to obtain the certificate however may prevent the corporation from suing in the courts of the state. If, after obtaining the certificate, the corporation does only an interstate business it will not be subject to the franchise tax. It must do intrastate business to be subject to the tax. On the other hand if a corporation is doing an intrastate business but has failed to obtain a certificate of authority to do business, it will still be liable for the tax. An inactive foreign corporation is therefore not subject to franchise tax. Foreign corporations are required to file form 245 CT, an activities report, each year if they disclaim liability for tax. On the basis of this report the Tax Commission determines whether the corporation is subject to tax.

In the case of corporations organized in New York at least the minimum tax is due each year, regardless of whether the corporation is inactive or not. The mere right to exercise its charter subjects it to tax.

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving on the Society's Committee on Federal Taxation, and its Committee on State Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Collection of Tax against Foreign Corporation

Under Section 203.2 if a foreign corporation fails to file a certificate designating the Secretary of State as its agent upon whom process may be served within the State, it shall be deemed to have done so. It is also deemed to have directed the Secretary of State to mail copies of process served upon him to the corporation at its last known address within or without the state. This provision plus the fact that the foreign corporation has done taxable business within the state gives the state proper jurisdiction over the corporation to proceed against it to collect a tax. On the basis of this jurisdiction, the state may obtain a judgment for the taxes due. To enforce collection it must bring an action on the judgment, usually in the domiciliary state of the corporation or in any state where property of the corporation can be found. Other states will give full faith and credit under the federal constitution to the judgment thus obtained in New York.

This procedure is of course long and indirect. In recent years a number of states have made the collection of taxes by other states easier, by permitting tax officials of other states to bring suit directly in the local courts against persons liable for tax. Those states that have opened their courts to tax collectors of other states have done so on a reciprocal basis, that is they permit the use of their courts to those states which extend a like privilege to them. States that have such laws include Alabama,

Georgia, Maine, Minnesota, Missouri, Oklahoma, Oregon, Tennessee, and Wisconsin. Some of these states will even enforce liabilities for penalties and interest charges imposed by the other states. New York does not as yet have any provision for recognizing and enforcing liabilities for taxes imposed by other states, but such a provision represents a modern trend which is likely to spread to the other states.

New Jersey Realty Title Insurance Co. v. Division of Tax Appeals

On February 6, 1950, the United States Supreme Court decided that a state property tax imposed directly or indirectly on United States bonds is invalid on the ground that it conflicts with Article 1, Section 8, of the Federal Constitution. This article authorizes Congress "to borrow money on the credit of the United States." A tax that reaches the bonds diminishes the attractiveness of the United States obligations and burdens the power of Congress to borrow. The tax also conflicted with Section 3701 of the Revised Statutes (1875), 31 U.S.C. Section 742, which generally exempts interest-bearing obligations of the United States from state and local taxation. The decision was rendered by Justice Clark. The Court was divided 7 to 1, Justice Black being the sole dissenter.

The particular tax was one levied by the City of Newark on the intangible personal property of a stock insurance company under a New Jersey statute. This law provides that the insurance company is taxable upon the full value of its property exclusive of real estate and tangible personal property, exclusive of all shares of stock owned by the company, and exclusive of non-taxable property and property exempt from taxation. The law also provides for certain deductions from the full value of the property. This provision virtually left to be taxed only the intangible property of the corporation not otherwise within the excluded classifications. There is a certain limitation in the statute which reads as follows:

> "the assessment against the intangible personal property of any stock insurance company subject to the provisions of this section shall in no event be less than 15% of the sum of the paid-up capital and the surplus in excess of the total of all liabilities of such company, *** ."

The insurance company filed a return showing its total assets of about $775,000; all of which were intangible. In arriving at the total taxable intangibles, the company excluded United States Treasury Bonds and accrued interest, and other nontaxable or exempt property. This left about $4,500 as total taxable intangibles. Deducting from this item debts, liabilities, and reserves left no balance of property subject to tax.

The taxing district therefore assessed a tax under the minimum provision of 15% of paid-up capital and surplus in excess of total liabilities. Justice Clark who wrote the opinion says at the very outset that this minimum basis clearly includes the government bonds and interest in the computation of the assessment.

The former New Jersey Supreme Court held the tax to be an ad valorem tax on personalty, which would be valid only if the bonds and interest were excluded from the computation. This ruling was reversed by the Supreme Court of New Jersey which held that the tax was not an ad valorem tax or property tax, but rather a tax upon the net worth of the company and, since the tax was non-discriminatory, it was constitutionally valid.

The United States Supreme Court held the tax invalid, whether it was considered as against capital and surplus less liabilities or against entire net worth. For precedents the court went back to two cases[1] decided in 1863 and in 1865. Justice Clark quoted from the Bank Tax Case where the Court said,

[1] *Bank of Commerce* v. *New York City*, 2 Black 620 (1863). *Bank Tax Case*, 2 Wall. 200 (1865).

"It is not easy to separate the property in which the capital is invested from the capital itself***. The legislature*** when providing for a tax on*** capital at a valuation*** could not but have intended a tax upon the property in which the capital had been invested*** such is the practical effect of the tax***."

On the basis of this observation in the earlier case, Justice Clark concludes that the tax is imposed on the United States bonds regardless of the accounting label employed in describing it, that is whether the tax is an excise, or indirect levy on net worth measured by corporate capital and surplus, or whether it is a tax on personal property based upon a valuation measured by capital and surplus. In practical operation and effect that tax is in part a tax upon federal bonds.

The New Jersey Supreme Court had held the tax valid on the authority of *Tradesmen's National Bank* v. *Oklahoma Tax Commission*.[2] But Justice Clark says that in that case the tax was not measured in effect by the amount of federal securities or interest, but was a franchise tax measured by net income. The New Jersey tax was not considered as a tax on a privilege or franchise.

On the question of whether the New Jersey tax was valid because it did not impose a discriminatory burden on federal securities, the United States court cites the old *Bank of Commerce* case as authority for the rule that a tax on corporate capital measured by federal securities may be invalid even though imposed without discrimination against federal obligations. As a matter of fact, the court found that the tax was actually discriminatory. It was contended that by taking only 15% of the net worth as a basis for assessment, consideration had been given to the exclusion for government bonds and interest. The court says that if such bonds were truly excluded from net worth then the assessment should have been based upon 15% of the net worth after taking the exclusion. Otherwise, the tax was being levied at a rate of over 79% of the assessable valuation, which resulted solely from the ownership of the federal bonds.

Implications of the Decision

A direct tax on capital is invalid if it is measured in part by federal securities. A tax on a percentage of paid-up capital and surplus is invalid if the tax base includes federal securities. The effect of the latter is to tax indirectly federal securities that may not be reached directly.

What of a franchise tax measured by net income or a franchise tax based upon gross assets (Article 9), or upon allocated business and investment capital (Article 9A). Logically, a tax on the right to do business as a corporation, where the tax is measured by tax exempt income or tax exempt assets, is an attempt to tax indirectly what it is invalid to tax directly. But the United States Supreme Court has held valid a franchise tax measured by income including interest on federal obligations[3]. In its opinion in this case, the court points to a number of cases that have upheld such a franchise tax measured by net property or net income including tax-exempt United States bonds. Said the court,

"This distinction (a tax on a franchise measured by tax exempt property and one directly on such property), so often and consistently reaffirmed, is but a recognition that the franchise, the privilege of doing business in corporate form, which is a legitimate subject of taxation, does not cease to be such because it is exercised in the acquisition and enjoyment of non taxables."

Justice Clark at one point in the *New Jersey Realty Title Insurance Co.* case discusses the decision of the lower court on this case. The lower court held the tax to be valid on the authority of two United States Su-

[2] 309 U. S. 560 (1940).
[3] *Pacific Co., Ltd. v. Johnson, Treas. of the State of Cal.* (1932) 285 U. S. 480.

preme Court decisions[4]. Justice Clark then distinguishes these two cases by pointing out that

> "the tax there considered*** was not measured in effect by the amount of the taxpayer's federal securities or interest but was a *franchise tax* measured by net income."

And even the early *Bank Tax Case* drew a distinction between a tax on property and a tax on franchises.

Prentice-Hall, Inc., in its New York Tax Report, Bulletins 16 and 17, discusses this case and its implications. It asks this question: Does the New York franchise tax measured by property or capital invalidly reach United States obligations? Prentice-Hall thinks the answer is yes, because the inclusion of such securities in the tax base impairs the attractiveness of the federal securities as investments and, as Justice Clark points out, that is a prohibited interference with the borrowing power of Congress. Prentice-Hall suggests that "taxpayers should omit them (federal securities) from future tax bases (with rider explanation referring to the New Jersey case) and file refund claims as to past payments where time has not lapsed."

In our opinion this decision is not authority for holding invalid a franchise tax measured by property or capital where a part of the capital consists of exempt federal securities. Nor is it authority for holding invalid a franchise tax based upon gross assets where these include exempt federal securities.

Loss on Sale of Real Estate— Capital Loss or Ordinary Loss

Under the income tax law, a loss on the sale of real estate is fully deductible if it can be classified as an ordinary loss, but if it is to be classified as a capital loss it is deductible only from capital gains. An ordinary loss deduction will reduce income subject to ordinary rates which are double the capital gain rates. A capital loss deduction may result in no tax benefit if there are no capital gains against which to offset the loss either in the current year or the five succeeding years to which the loss may be carried over. The classification of the loss thus becomes important. The Tax Commission has interpreted the statute with what may appear to be undue severity from the taxpayer's point of view. Its policy is not to permit deductions for losses on the sale of real estate as ordinary losses, unless the taxpayer is engaged in business as a real estate dealer.

Section 360.4 of the Income Tax Law allows as a deduction from ordinary gross income "losses other than capital losses sustained during the taxable year * * *, if incurred in *trade or business*." (italics ours). And the law (section 360.5) allows as an ordinary loss "losses other than capital losses * * * if incurred in any transaction entered into for profit *though not connected with the taxpayer's trade or business;*" (italics ours). The regulations (Article 151) appear to be in accord with the law.

Section 350.12 of the law defines the words "capital assets" as "property held by the taxpayer (whether or not connected with his trade or business), but do not include * * * or property held * * * primarily for sale to customers in the ordinary course of his trade or business * * *." There is no counterpart to Section 117j in the state law relating to certain property used in a trade or business which, if held for more than six months and sold at a profit, may be treated as a capital gain, but if sold at a loss may be treated as an ordinary loss.

The Tax Commission appears to minimize the provision in the law that a loss may be deductible as an ordinary loss, though not connected with a trade or business. It also seems to restrict the meaning of trade or business. The federal rule is more realistic and more liberal. Black's Law dictionary defines the terms "business" and "trade" as follows: "Business is a very compre-

[4] *Tradesmen's National Bank* v. *Oklahoma Tax Commission,* 309 U. S. 560 (1940), and *Educational Films Corp.* v. *Ward,* 282 U. S. 379 (1931).

hensive term and embraces everything about which a person can be employed." Bouvier defines the terms as "that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit."

Take the case of a taxpayer whose activities are concerned almost exclusively with real estate. He buys properties and usually transfers each property to a separate corporation which then operates the property. Occasionally, he will decide not to retain the property, in which case he sells it. If he disposes of the property at a loss, is this an ordinary loss or a capital loss. The Tax Commission contends that it is a capital loss, since the taxpayer as an individual is not a dealer in real estate; he is not in the real estate business. Such a determination may seem to be unrealistic in the case of a taxpayer all of whose activities revolve around real estate. It should be noted however that the Tax Commission is consistent in its position in that it will treat a gain in such a case as a capital gain. It does not do what the Commissioner of Internal Revenue frequently does, i.e., take an inconsistent position merely because that will bring in more revenue.

Under the Internal Revenue Code property is used in a trade or business "where the owner * * * devotes it to rental purposes and exclusively to the production of taxable income."[5] In this case, the taxpayer was a lawyer and this was the only real estate he operated. In a later case[6] the Tax Court held that ownership of rent-producing realty in itself is a trade or business, and a loss on the sale of the real estate is fully deductible. The Tax Commission considers each case on the basis of its own facts. It seeks to determine whether the taxpayer is devoting time, attention and labor with some continuity to the operation of the particular real estate. If it finds enough activity to constitute a business it will so find and allow a deduction for a loss on the sale of property as an ordinary loss. If not, it will treat the loss as a capital loss, one resulting from an investment in real estate, similar to a loss on the sale of stock.

In a case[7] arising under the Unincorporated Business Tax Law, the court held that where owners of realty maintained no office of their own, nor a clerical staff, all property matters being transacted through an agent, they were not liable for an unincorporated business tax. They held the property only for income purposes as an investment and were not engaged in a business. By itself, ownership and management of realty does not constitute an unincorporated business.

In one income tax case,[8] the Court held that the ownership and rental of a farm did not constitute engaging in business, and a loss resulting from a sale would be a capital loss. In this case the owners were not otherwise engaged in farming, in real estate transactions, or with the farm they owned and sold.

Franchise Tax—Article 9A—Fiscal Year Taxpayers

On February 21, 1950, Governor Dewey signed a bill requiring fiscal year corporations to file franchise tax returns three and one-half months after the close of the fiscal year. One-half the tax is payable with the filing of the return and the remainder by the first day of the eighth month after the close of the fiscal year. The new law becomes effective for all corporations whose fiscal years end after July 1, 1950.

Calendar year corporations continue to file the franchise tax return by May 15. The first payment of one-half the tax is due at that time. The remainder

5 *Fackler* v. *Com'r*, 45 BTA 708, aff'd., 133 F(2d) 509.
6 *Goldsmith* v. *Com'r*, TC Memo 5/29/46.
7 *Nauss* v. *Graves*, 283 N. Y. 383.
8 *Johnson* v. *Browne*, 273 App. Div. 1041 (1948).

of the tax is due on or before the succeeding 15th day of November or within 30 days after notice of the tax has been given if such notice is given after October 15. But the tax must be paid by the following January 15th, regardless of any notice. This year many taxpayers were disagreeably surprised at receiving a bill for the balance of franchise taxes due for 1949, with penalties added by reason of non-payment by January 15, 1950. Since the new law is effective only for corporations with fiscal years ending after July 1, 1950, those corporations whose fiscal year ends before July 1, 1950, must file their 1950 returns four months after the end of the fiscal year.

Franchise Tax—Article 9—Real Estate Corporations

On March 3, 1950, the governor approved a bill which provides that if a real estate corporation becomes taxable as a business corporation under Article 9A, the tax as a real estate corporation shall be prorated. Until this bill was passed the corporation was not taxed as a real estate corporation for the year of the changeover, since it had satisfied all tax liability for the privilege year in which the changeover occurred by its tax based on the preceding year, and its new tax liability under Article 9A began only as of the date of the changeover. The method of prorating the tax is not indicated in the law. Presumably if the real estate return has already been filed, an amended return would have to be filed and a refund claimed. Perhaps the Tax Commission will permit a credit for the refund due against the first franchise tax return filed under Article 9A. Some ruling will probably be issued for computing the credit. It should be noted that the two percent tax on dividends payable upon a change of classification is not to be prorated. This bill also provides that any consideration given by a corporation for the purchase of its own stock in excess of the consideration received by the corporation for the issuance of the stock shall be taxed as a dividend distribution. Such excess would thus be subject to the 2% tax on dividends paid during the year.

Claim for Refund—Income Tax

A claim for refund must be made by filing an application for revision on form I.T. 113. The application must be filed within two years from the time of filing a return or within one year from the mailing of a notice of assessment to which the taxpayer takes exception. There is no procedure under the law for claiming a credit on a current return for a refund claim for any prior year. Tax liability is computed separately for each taxable year.

Real Property Exempt from Taxation—Veterans

In 1946 the legislature passed a law exempting from taxation to a veteran real property purchased with the proceeds of a pension, a bonus, or insurance granted by the United States. The 1950 legislature extends the exemption to real property purchased with dividends or refunds of National Service Life Insurance. The 1949 legislature had passed a law providing that the mingling of pension, bonus, or insurance money with other funds shall not bar the granting of a claim for exemption.

This exemption extends to the wife or widow of the veteran, to a dependent mother or father, or to minor children. The maximum amount that may be exempt is $5,000. Such real property is exempt from state, county and general municipal taxation. It is however taxable for local school purposes. The exemption applies whether the veteran is living or deceased.

Blocked Foreign Income

The Commissioner of Internal Revenue recently issued a ruling (Mim. 6475, March 1, 1950) on the treatment of foreign income that is not available

to a taxpayer because of currency restrictions in the foreign country. Under this ruling a taxpayer may now defer the income for tax purposes until it becomes convertible into United States dollars, regardless of whether the taxpayer is otherwise on the accrual or cash basis. Under the ruling, if the taxpayer uses any of the foreign income for personal expenses, which he might do if he were traveling in the foreign country, the foreign income would be taxable when the taxpayer so uses any of the income. It also becomes taxable if the taxpayer disposes of any of the income by gift or inheritance. If the taxpayer is a corporation it becomes taxable if the corporation distributes any of the income as a dividend. If a resident alien earns such income it becomes taxable when the resident alien terminates his residence in the United States.

The state also has had this problem. It has not taxed blocked income until it becomes available. It has considered foreign income used for personal expenses as available income. There is a provision in the regulations (Article 524) providing that where there is a change of status from that of a resident to that of a nonresident or the reverse, the return for the period prior to the change must be made on the accrual basis regardless of the established method of reporting income. The termination of residence in New York could under the regulation subject blocked income to tax.

Under Mim. 6475, if the taxpayer elects to treat blocked foreign income as "deferable foreign income," he must file a separate information return reporting such income and a separate return is required for each country in which such income is earned. In addition to deferring the income, related costs, expenses, and depreciation must likewise be deferred until the income is made available and taxable. Similarly, losses and bad debts must be deferred. The election to treat income as deferrable may be made in the current year or for any preceding year still open, and once this election is made no change in the accounting procedure may be made without the Commissioner's consent.

AN ADIRONDACK VIEW

DOWN THE STAIRS. Wish I knew all the answers—that is the right ones. The bones of contention about which business is now having dog-fights (and in the front yard, too) are pensions and retirement. The coal industry gnawed on such a bone this winter; while the miners' kids went without enough to eat, the railroads limped along without enough coal, hospitals decreased their heat, and some schools closed.

Then the Chrsyler crowd got hold of another such bone; and, while the city fed workers' families, the dog-fight went on, and on, and on, with much growling and biting.

The question is, what should industry do for its workers when they get old? The only answer that is being propounded is—retire them on a pension. And $100 a month is the magic figure! Most questions have several answers, that is, there is more than one way to skin a cat, go from Albany to Saranac Inn, or catch a mess of trout.

Getting the problem down to base facts we find we have:

1. A certain person, a normal human being.
2. He has worked for many years for one concern, gone there each day, worked there each day, and left when the gong clanged.
3. As the years went along his pay increased, and his abilities increased.
4. Then he gets to be age 65 (or 70, or something).

Bang! He isn't any good anymore. That's a crazy idea if you ever saw one—and you have seen plenty. Retirement is not the answer. The older employee needs to go down the stairs he has climbed up—not get shoved out the window. He needs less exacting work, for less pay, with less pressure. Let him work down the same as he worked up. There is more to retirement and pensions than reserve accounts and actuarial factors.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Independence of Certifying Public Accountants

(Part II)

In our April, 1950, issue reference was made to a compilation of 20 cases published by the Securities and Exchange Commission in 1944, in which it was held that the certifying accountant was not independent with respect to a particular company. Two of the cases in that compilation, as condensed by the S.E.C., were quoted in the April, 1950, issue; others are as follows:

6. An accounting firm had rendered services to a registrant for which the registrant had not been able to pay. To guarantee payment of the account the registrant had pledged shares of its own stock. In addition it had given the accountants an option to purchase the pledged securities at the market price existing at the date the option was given. *Held,* the accounting firm could no longer be considered independent for the purpose of certifying the financial statements of the registrant.

10. A partner in an accounting firm had served on the board of directors of a registrant but had resigned from that position prior to the close of the most recent fiscal year. This accountant had not participated in any way in the accounting firm's audits of the registrant. *Held,* that the accounting firm could not be considered independent for the purpose of certifying financial statements of the registrant covering any period during which a partner of the accounting firm was a director of the registrant.

14. The board of directors of a registrant had established an "operating committee" in which had been vested all powers necessary and appropriate to the supervision of the management of the business. It was intended that the principal duty of the committee would be the making of recommendations to the board of directors. The committee consisted of two members of the board of directors and a member of the accounting firm that regularly certified the financial statements of the registrant. *Held,* neither the individual accountant nor his firm could be considered independent for the purpose of certifying the financial statements of the registrant.

16. An individual serving as assistant treasurer and chief accountant of a registrant was the son of a partner in the accounting firm that certified the financial statements of the registrant. The son was living with his father at the time. The son served the registrant under the direction and supervision of the treasurer of the company. *Held,* the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant.

17. A senior staff member of an accounting firm was appointed controller of a registrant as successor to a controller who had entered the armed forces of the United States during the war emergency. This employee, who had formerly been in charge of the audit of the registrant, remained on the staff of the accounting firm but relinquished all responsibility for the audit of the registrant, and did no work for the accounting firm in connection therewith. *Held,* the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant. *Held,* further, the accounting firm could not be considered independent for the purpose of certifying the financial statements of the registrant if the senior staff member were to leave the employ of the accounting firm and be paid by the registrant, but this arrangement was subject to the understanding among the several parties that upon the termination of the war emergency he would return to the staff of the accounting firm.

18. The accountant who audited the financial statements of an investment trust had been given office space in the office of the sponsor of the investment trust. The accountant regularly gave advice concerning

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the internal accounting policies of the trust. The sponsor of the trust had agreed to pay the accountant a stipulated amount per year less whatever the accountant was able to earn from the investment trust and his other clients. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of the investment trust.

19. The accounting firm that certified the financial statements of a particular registrant had in the past followed the practice of drawing up the monthly journal records of the company from underlying documents that had been prepared by the registrant's staff. These journal records were posted to the appropriate ledgers by the certifying accountants. At the end of the year the audit engagement was undertaken by personnel of the certifying accountant that was not connected with the original recording of the accounting data. *Held,* the accounting firm could not be considered independent for the purpose of certifying the financial statements of this registrant.

20. A small loan company kept its accounting records on a cash basis. The primary records of the company consisted of daily cash reports that were prepared by the cashier and signed by the manager. The accountant who certified the financial statements of this company took no part in the preparation of these basic records. However, he did audit these cash reports each month and then proceeded to enter the totals in a summary record which he in turn posted to the general ledger. The certifying accountant also made adjusting journal entries each month with respect to insurance, taxes, depreciation, and similar items. The company was small and did not require the services of a full-time bookkeeper. The certifying accountant devoted about one day a month to the clerical or bookkeeping tasks described above. *Held,* the accountant could not be considered independent for the purpose of certifying the financial statements of this registrant.

What Is New in Alimony Cases?

(Continued from page 308)

prevent opposing statements of fact on the other, then greater recognition should be given to decrees. For example, retroactive decrees should qualify all payments made subject thereto. Payments made pendente lite and counsel fees paid on behalf of the spouse should all constitute deductible alimony.

There should be a clarification of the statutory phrase "agreement incident to a decree." At the present time the courts are in a sorry state of disagreement on the problem. There is a need for a more realistic and consistent viewpoint on the subject.

As long as our general laws on alimony continue to be antiquated, there are, of course, limitations to the extent that our tax laws pertaining to alimony can be liberalized. However, since our tax laws are not hemmed in by the common law limitations of our ancient antecedents, liberalization rather than strict construction should be the policy.

ADDENDUM

Since the writing of this paper, two new cases were decided concerning the deductibility of legal fees in alimony cases which should be of special interest.

In the case of *Elsie B. Gale,* 13 T.C. 84, the taxpayer, a divorced wife, made application for an increase in alimony which she obtained. Thereafter, she deducted the legal fees for tax purposes. Contrary to the Commissioner's argument, the Tax Court held that the fees paid for obtaining the increase were ordinary and necessary expenses incurred for the production of income.

In a second case, *Barbara B. LeMond,* 13 T.C. 85, the taxpayer, a divorced wife, paid legal fees in connection with obtaining a financial settlement incident to a divorce decree. The Tax Court here again held the legal fees deductible as expense incurred in the production of income. The Court went further and allocated the legal fees partly to the allowance for periodic payments and partly to lump sum payments, and treated the portion allotted to the lump sum payment as non-deductible.

These two cases merely accentuate, in my opinion, the lack of equity inherent in the tax treatment of alimony problems. Despite the logic of these two determinations, they merely point out a need to make statutory changes to afford the payors of alimony some consolation, at least in the nature of a tax deduction, for legal fees expended in an effort to keep their alimony payments as low as possible.

Book Reviews

(Continued from page 265)

planation of how the Treasury Department works with the professional representative of the taxpayer—a void which this book may fill because this need is not satisfied by the current loose leaf tax services. On the other hand, no bound volume can safely be used by a tax advisor as a tool of his trade; it goes out of date as surely and almost as quickly as a newspaper. Perhaps the best characterization of the "Lawyers Tax Manual" would be that it is a well written sophisticated text book on professional tax practice.

LESLIE MILLS

New York, N. Y.

Internal Auditing in Industry

(Developed under the Direction of The Research Committee of The Institute of Internal Auditors.) Edited by Victor Z. Brink and Bradford Cadmus. THE INSTITUTE OF INTERNAL AUDITORS, 120 Wall Street, New York, 1950. Pages: xi + 404; $5.00.

This work, the outcome of a two-year project of the Research Committee of the Institute of Internal Auditors, deals with internal auditing procedures in specific industries. The problems of managerial and accounting control are discussed briefly in the first chapter. The remaining chapters, devoted to the procedures followed in specific industries, have been prepared by persons active in the industries and associated with nationally-known companies.

The coverage ranges from Air Transport to Publishing and Printing, and includes Automotive Manufacturing and Distribution; Banking; Chain Stores; Construction; Department Stores; Food Processing; Insurance; Meat Packing; Metals-Ferrous,—Non Ferrous; Mining; Motion Pictures-Production, Distribution, Exhibition; Petroleum-Exploration and Production, Refining, Marketing; Public Utilities.

In the individual industry chapters emphasis is placed on the description of the actual physical operations and the operating structure of the industry, the editors noting that "description of the actual problems will immediately serve to identify the major and special control problems."

The editors take for granted that the reader "is familiar with the normal accounting and control methods . . . generally used for handling items such as cash, payrolls, and property." Accordingly, emphasis is transferred to the unusual phases of operations "with virtual exclusion of description or coverage of any portion of . . . (the industry's) work which is the same as (in) the majority of other businesses."

A typical chapter, that on Publishing and Printing, contains 21 pages. Internal auditing in the industry is discussed under these subdivisions: Descriptive; Special Problems and Risks-Selection of Material, Author Contracts and Royalties, Inventories, Book Plates, Sales and Subscriptions, Income from Advertising, Printing; Accounting and Operating Controls (treating each of the above Special Problems and Risks); Conclusion.

A somewhat longer chapter, dealing with Public Utilities, presents the subject matter under these headings: Electric; Gas; Telephone; Problems and Risks; Utility Regulation; Accounting, Internal Control, and Internal Auditing Problems. Under the latter subdivision are considered: Customers' Accounting; Commercial Accounts; Deposits; Rates and Metering; Cash Receipts; Unpaid Accounts; Proof of Billing; Coin Telephone Collections; Distribution of Line Agreements; Materials and Supplies; Coal; Rights of Way; Franchises and Real Estate; Property and Plant; Salvage Materials.

The internal auditing procedures reported in the various chapters of the book are presented in sufficient detail to be of value to accountants unfamiliar with the particular industries. Public accountants whose practice embraces one or more of the fields covered will find the book useful in appraising the methods of internal auditing and internal control employed by clients. Further, the methods followed in particular industries will undoubtedly suggest possibilities of adaptation to others.

The book should have wide appeal to public accountants.

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